MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 16, 1971, at 9:30 a.m.

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

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

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Bernard and Molony, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Eisenmenger, Gramley, Hersey, Scheld, Solomon, Taylor, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Altmann, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Chase, Deputy Director, Division of Research and Statistics, Board of Governors
Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Associate Adviser, Division of International Finance, Board of Governors
Mr. Zeisel, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Rehanek, Secretary, Office of the Secretary, Board of Governors

Mr. Leonard, First Vice President, Federal Reserve Bank of St. Louis
Messrs. Parthemos and Craven, Senior Vice Presidents, Federal Reserve Banks of Richmond and San Francisco, respectively
Messrs. Boehne, Hocter, and Green, Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Messrs. Meek, Puckett, and Bowsher, Assistant Vice Presidents, Federal Reserve Banks of New York, New York, and St. Louis, respectively

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on October 19, 1971, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on October 19, 1971, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period October 19 through November 10, 1971, and a supplemental report covering the period November 11 through 15, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the chief uncertainty in the exchange markets at the moment was the question whether the U.S. Government would or would not concede a token increase in the gold price and thereby explicitly devalue the dollar. Market discussion had focused on a possible gold price increase of 5 per cent, coupled with a widening of the margins to 2-1/2 per cent on either side of parity.

Although the Bank of Japan had allowed the yen to rise to nearly 10 per cent above its previous parity, Mr. Coombs continued, the market had been led to believe that an increase in the U.S. gold price would encourage the Japanese to do still more; and speculative buying pressure on the yen naturally continued. In the case of sterling, the market assumed that the British Government would not contribute an outright revaluation of

sterling, but it might well permit a 5 per cent devaluation of the dollar against all European currencies including sterling. That would mean a new sterling parity of roughly $2.53 and, if the band for sterling were set at 2-1/2 per cent on either side of the new parity, new lower and upper limits of $2.47 and $2.59. The prevailing rate for sterling of slightly more than $2.49 still looked pretty attractive if one expected such a 5 per cent change in the U.S. gold price, and so speculative buying of sterling had also continued. The British authorities, who seemed more impressed than the market by their 10 per cent inflation rate and record unemployment, had been intervening firmly whenever the rate had moved much above the $2.49 level. They seemed fearful that a higher sterling rate now might fall back abruptly on profit-taking following a parity realignment and so attract speculative interest in the pound, against the background of some serious weaknesses of the British economy.

In the case of the Dutch guilder and the Belgian franc, Mr. Coombs said, the appreciation of about 6 to 7 per cent in those currencies before the System Account began buying Belgian francs and the Belgian National Bank began buying guilders would seem to reflect market guessing that a 5 per cent increase in the U.S. gold price might be accompanied by small revaluations--perhaps 2 per cent--of the Belgian franc and the Dutch guilder. In the case of the German mark, Minister Schiller had repeatedly suggested a target revaluation against the dollar of no more than

8 per cent, whatever might be the percentage increase in the U.S. gold price. The floating rate on the mark had consequently drifted from an earlier peak of 11 per cent above par to the current 9.5 per cent, with further declines quite possible. Central bank intervention plus controls in France, Switzerland, and Italy had produced market rates which were not particularly meaningful, but would seem to suggest that those three countries would be reluctant to throw in a revaluation on top of a U.S. gold price increase.

Meanwhile, Mr. Coombs remarked, the key to the parity realignment problem increasingly seemed to be the policy conflict between France and Germany, which presumably would be the main subject of the meeting between Chancellor Brandt and President Pompidou around the end of this month. In that policy encounter, the bargaining advantage seemed to have shifted considerably in favor of the French, who had made at least a temporary success of their two-tier system, while criticism of Mr. Schiller's decision to float the mark last May was steadily mounting in Germany.

Finally, Mr. Coombs said, he would like to draw the Committee's attention to Mr. Bodner's report on exchange market conditions[1/] which differed somewhat from the embassy reports on

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1/ The report referred to was in the form of a memorandum from Mr. Bodner to Mr. Coombs, dated November 12, 1971, and entitled "The Current State of the Foreign Exchange Markets." Copies were distributed at the meeting and a copy has been placed in the Committee's files.

the same subject summarized in Appendix C of the green book.[1/] In his (Mr. Coombs') view, what had happened in the exchange markets since the advent of floating rates in mid-August was just about what he had expected to happen, and it had confirmed all of his worst fears. First of all, the illusion of freely floating rates adjusting automatically to market forces had been thoroughly shattered. Government intervention to manage floating rates was inevitable and had brought about in the last month or so a de facto stabilization under which rates had moved hardly more than they might have done under a fixed rate system. Such central bank stabilization of exchange rates had naturally encouraged a recovery of short-term commercial transactions through the exchange markets, although volume in many markets remained far below earlier levels.

Beneath the surface impression of orderly trading in the spot exchange markets, however, Mr. Coombs thought there was a continuing erosion of business confidence in the outlook for foreign trade and investment. In the forward markets, coverage of exchange risks beyond six months had become so difficult that new export contracts involving medium- and longer-term deliveries were being severely depressed. There also was a continuing shift from dollar invoicing as foreign exporters increasingly

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

insisted on quoting contracts in their own or other currencies. The oil companies had been forced into new negotiations with the oil producing countries, who were demanding compensation for the depreciation of their dollar income from oil sales. In effect, the role of the dollar as a transaction currency, as well as a reserve currency, was beginning to be adversely affected.

More generally, Mr. Coombs observed, the uncertain outlook for foreign trade seemed to be aggravating recessionary tendencies in Europe, where domestic economic prosperity had been closely geared to a high and rising volume of world trade. Just for illustration, German exports amounted to about 18 per cent of GNP, while in the case of the Netherlands the figure came to 35 per cent. In those and other countries, a slowing down of new business investment oriented towards export sales could have a rather pervasive depressing effect, and could also have consequences for the United States in the form of less buoyant demand for its exports and a falling off of its earnings from overseas investments. Exchange rate uncertainties clearly were also contributing to foreign reluctance to make new placements in the U.S. stock market, despite severely depressed stock market conditions in Europe. What worried him most was that international currency uncertainties seemed to be having a depressing effect on business and investor sentiment here at home.

However, Mr. Coombs said, the main risk of a floating rate system still lay ahead. Floating rates were essentially a fair weather system, and the present situation--in which all major foreign currencies were simultaneously being pushed upward against the reserve currency, the dollar--represented the minimum of potential strain on the floating rate system. The real test would come when one or more foreign countries slipped into trouble and their exchange rates came under selling pressure. Under a floating rate system, speculation could then drive their rates down so far as to seriously undercut the competitive position of other countries, which would then be forced to take defensive action of their own. That basic risk of the present floating rate system pointed up the urgency of returning to a system of fixed parities as soon as possible.

Mr. Heflin asked whether the monetary officials in other countries thought that interest rate declines in the United States--including the recent cut in the discount rate--had contributed undesirably to upward pressure on their exchange rates.

Mr. Coombs replied that at the moment interest rates were declining cyclically in other major countries as well as in the United States. Accordingly, rate declines here were less likely to be a source of conflict now than at other times.

Mr. MacLaury referred to Mr. Coombs' comment that exchange rate uncertainties were contributing to recessionary

tendencies in Europe which in turn could have repercussions in U.S. markets. He did not doubt that that view was widely held. At the same time, it was clear that an adjustment in international trading patterns would be required if the United States was to achieve a significant improvement in its trade accounts. He wondered about the extent to which the recessionary tendencies in Europe and their repercussions in U.S. markets were attributable simply to the fact that such an adjustment was needed, rather than to problems posed by the situation in exchange markets.

In reply, Mr. Coombs observed that a relatively small part of the trade of Common Market countries was with the United States, so that the adjustment Mr. MacLaury had mentioned should not be a major problem for them. In his judgment those countries were more concerned about the risk of a general breakdown of financing and other broad arrangements governing the network of international trade, particularly their trade with one another.

Mr. Brimmer remarked that some of the analysis being done in preparation for a meeting of the Economic Policy Committee of the OECD, to be held in Paris later this week, was relevant to the question Mr. MacLaury had raised. The American embassy in each OECD country had been asked to make a survey of economic conditions there, distinguishing between tendencies that had been evident at the time the new economic program was announced in mid-August and those that had developed subsequently.

The report for Germany indicated that a considerable degree of economic weakness had already developed by mid-August. While recent uncertainties about foreign exchange rates were affecting investment and investment planning to some extent, the prospect of a marked slowing of growth could not be attributed directly to the measures the U.S. had taken. Substantially the same conclusion was reached for a number of other countries, and those findings seemed to be supported by the fact that very few countries thus far had taken any retaliatory action. No doubt the foreign exchange market uncertainties were contributing to domestic economic problems in foreign countries, and he would not want to minimize the possibility of further effects. However, he did not think the uncertainties could be said to be the direct cause of those problems.

Mr. Coombs said he concurred with Mr. Brimmer's conclusion and had meant to indicate only that the uncertainties were aggravating recessionary tendencies abroad. In his judgment the situation was a particularly dangerous one because the new uncertainties had arisen at a time when foreign countries were experiencing economic difficulties.

In response to a question by the Chairman regarding recent System transactions, Mr. Coombs noted that the Desk had stopped buying Belgian francs for the time being at the request of the National Bank of Belgium.

In reply to questions by Mr. Mitchell, Mr. Coombs said the System had lost about $5 million in its recent operations paying down Belgian franc swap debt. Minor losses had been incurred from time to time in the past, but from the inception of foreign exchange operations in 1962 the System had realized about $350 million net in profits and other income resulting from those operations. Further losses undoubtedly would be incurred in repaying the remaining balances outstanding on the swap line; their magnitude would depend on the exchange rates prevailing at the time the needed currencies were acquired. At the moment there was an outstanding request from the National Bank of Belgium for repayment of swap drawings totaling $105 million which would mature on January 3, 1972. However, the extent to which the Belgians would actually seek repayment would depend on the ability of the System to acquire the necessary francs in the market without unduly affecting the exchange rate. On the basis of their present attitude, he would expect them to prefer to roll over any amount that could not be covered in that way.

In reply to a question by Mr. Brimmer, Mr. Coombs said that recent System purchases had pushed up the premium on the Belgian franc by about 1-1/2 points, from about 5-1/2 to about 7 per cent. It was because of that rate effect that the Belgians had asked the System to suspend its purchases. They were now

considering the question of the acceptable magnitude of upward pressure on the rate, and he expected to learn shortly what conclusions they had reached.

> By unanimous vote, the System open market transactions in foreign currencies during the period October 19 through November 15, 1971, were approved, ratified, and confirmed.

Mr. Coombs then said he had only one recommendation to make today, but it involved a major question relating to the entire swap network. All of the System's standby swap arrangements would reach the end of their annual terms in the period from December 2 through December 30, and the question was whether the Federal Reserve should seek their renewal for another year. In the past the System had always taken the initiative with respect to renewals.

Mr. Coombs remarked that the rationale of the swap network rested on two main considerations. First, the network enabled the System to shield the Treasury gold stock and other reserve assets by providing the alternative of an exchange guarantee to foreign central banks having dollars they wished to convert. In effect, the Treasury held about $3 billion more in reserve assets now than it would have if the Federal Reserve did not have that amount of debt outstanding on the swap line. That part of the rationale had now fallen away, since the decision of August 15 had made the dollar inconvertible into gold or other

reserve assets. The Administration had asked the Federal Reserve not to make further drawings on the swap lines, but even in the absence of such a request he would not have recommended drawings so long as the dollar was inconvertible.

The second part of the rationale, Mr. Coombs continued, was that the availability of swap credits to foreign central banks would enable them to resist disorderly devaluations of their currencies that would indirectly undermine the strength of the dollar in world markets. The swap network might still have a role to play in that area. More generally, the swap network had come to be regarded in the market as the very symbol of central bank cooperation, and an abrupt abandonment of the network at this time might well exacerbate still further the fears and uncertainties besetting the international markets. Accordingly, he thought it would be desirable to send messages in the usual routine way to the System's swap partners, requesting renewal of the various swap arrangements for another year.

Mr. Coombs noted that the subject had been discussed with Treasury officials, but he understood that the Treasury had not yet arrived at a final position. He recommended, therefore, that the Committee approve renewal of the System's swap lines for further periods of one year, subject to a determination by the Chairman that such action was in the national interest.

Mr. Daane said he would support that recommendation. A refusal to renew the swap lines would add to existing uncertainties, as Mr. Coombs had suggested; and it could be interpreted as an aggressive action carrying implications with respect to the likely future convertibility of the dollar which would not be intended. It was his view, and also the general view of the Treasury officials with whom he had discussed the matter, that the System should proceed to propose renewals in its normal routine fashion, without pressing. At the same time, he agreed that the Committee should make its action approving renewals conditional on the suggested determination by the Chairman, which presumably would be made after further discussions with the Treasury.

Mr. Daane added that the question of the swap lines had been raised in informal conversations at the latest Basle meeting by a few of the governors present. Those governors were favorably inclined toward renewal of the lines.

Mr. Coldwell asked whether Mr. Coombs had received indications that any of the System's swap partners would resist renewal.

Mr. Coombs replied that no effort had yet been made to ascertain the attitudes of the central banks involved. However, two or three of them had volunteered the information that they expected the lines to be renewed. He would not be surprised if some central banks responded to a routine inquiry with a qualified acceptance--perhaps suggesting that the revaluation clause be held in abeyance

pending settlement of the question of exchange rate realignments. It was quite possible that an accommodation could be worked out on any such questions, particularly since the System did not plan to draw on the lines and since it was unlikely that foreign banks would want to do so in view of the size of their dollar holdings. However, if the qualifications were unacceptable he would propose to react as in the past--by indicating that the Federal Reserve would prefer to let the swap line lapse rather than press for an arrangement the other party did not believe was in its interest.

Mr. Brimmer said he supported Mr. Coombs' recommendation regarding renewal of the swap lines. However, he would like to know what the prospects were for paying down the outstanding System debt on lines other than that with the National Bank of Belgium.

Mr. Coombs replied that, as he had mentioned at the previous meeting of the Committee, the British and the Swiss had asked the Federal Reserve not to enter the market to buy their currencies for the purpose of paying down the System's debt to them. They were quite content to renew the outstanding drawings, in the expectation that when new parities were established there would be very large return flows of currencies which would provide ample means for repayment. He personally would not anticipate any difficulty in making repayments at that time, since the recent flows to London and Zurich primarily involved speculative money that was now away

from its natural home and was earning very little interest. As soon as things settled down that money would come back.

In response to the Chairman's request for comment, Mr. Solomon said the Board's staff concurred in Mr. Coombs' recommendation regarding renewal of the swap lines. It would be desirable to proceed in a manner consistent with the objective, as expressed by the Treasury, of not giving the impression that the dollar would become convertible at an early stage.

Mr. Solomon added that there was one aspect of the more general question which he would like to bring to the Committee's attention--namely, that the swap arrangement with the Bank of England, which was in the amount of $2 billion, appeared to be disproportionately large. Except for the $1-1/4 billion arrangement with the Bank of Italy, no other System swap line exceeded $1 billion. The British line had been raised to its present size at a time when sterling was under very great pressure. Given the facts that Britain would be joining the Common Market, that the role of sterling was likely to be less of a special one in the future than in the past, and that the United States was likely to regard its participation in the defense of a sterling parity to be less urgent, it might be appropriate at some point to reduce the Bank of England arrangement to a size more in line with those of other major countries. He would not recommend such action during the present period of uncertainty

since the announcement would be subject to misinterpretation. However, the Committee might want to have some informal conversations undertaken with the Bank of England concerning a possible cutback in the line at a future time when economic and political considerations made it appropriate.

Mr. Coombs said he agreed with Mr. Solomon except on two points. First, he was not at all sure that the United States would be considerably less concerned in the future than it had been in the past about what happened to the exchange rate for sterling; movements in that currency affected the whole sterling area, and large changes in its value or a shift to a floating basis could have great repercussions. He would not underestimate the impact on international finance generally of a breakdown in sterling. Secondly, there might be leaks if informal conversations were held with the British about the size of the swap line, and he did not think the need for such conversations now was sufficiently great to warrant incurring that risk. He might note that if the timing depended on the date the British joined the Common Market there would be at least a year available in which to hold the discussions.

Mr. Daane observed that he concurred in the comments of both Mr. Solomon and Mr. Coombs. He had felt for some time that it might be desirable to reduce the size of the swap line with the British, but he would not want to press the matter at this point in

a way that could result in undesirable publicity. He thought the Committee should keep in mind the points made by Messrs. Solomon and Coombs.

Chairman Burns said he thought that nothing should be done at this time.

Mr. Brimmer said he would like to return to the question of paying down the outstanding System swap drawings. He took some comfort from the fact that the Belgian franc had appreciated recently, since that was consistent with the general U.S. interest in seeing further appreciation of foreign currencies. By the same token, however, he was disturbed by the fact that the exchange rates for other key currencies had been drifting down since mid-September. At least for the currencies in which the System had debt outstanding, that tendency could be reversed by System purchases in the market.

Mr. Coombs said he was not surprised that the exchange rates for a number of currencies had declined in recent weeks; indeed, what surprised him was that they had not come down more than they had. On the general point, as he had noted, both the British and the Swiss had indicated that they were strongly opposed to U.S. purchases of their currencies for the purpose of debt repayment, and that they were quite willing to roll over the outstanding debt. For the System to operate in their currencies against their wishes

would lead to a serious policy conflict with political overtones--an outcome he hoped could be avoided.

Mr. Brimmer said he was prepared to accept the fact that the balance of considerations argued against paying down those debts. At the same time, he thought it was worth noting that such a course was not consistent with U.S. objectives in the area of exchange rates.

Mr. Coombs remarked that in his view this country's interests would not be served by System operations designed to push exchange rates up to artifically high levels. The best exchange rates, in his judgment, were those that reflected normal trade and capital movements.

Mr. Hayes commented that a fundamental premise of the System's swap network had always been that operations would be carried out only if they were jointly agreed to by both affected parties. He would not want to deviate from that approach at this time.

Chairman Burns remarked that every effort should certainly be made to avoid conflicts with other countries. He then asked whether there were any objections to proceeding along the lines Mr. Coombs had recommended with respect to the renewal of the swap arrangements.

No objections were expressed.

By unanimous vote, the Committee approved the renewal for further periods of one year of the following swap arrangements, having the indicated amounts and maturity dates, subject to a determination by Chairman Burns that such action was in the national interest:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Maturity date
Austrian National Bank	200	December 2, 1971
National Bank of Belgium	600	December 22, 1971
Bank of Canada	1,000	December 30, 1971
National Bank of Denmark	200	December 2, 1971
Bank of England	2,000	December 2, 1971
Bank of France	1,000	December 28, 1971
German Federal Bank	1,000	December 16, 1971
Bank of Italy	1,250	December 30, 1971
Bank of Japan	1,000	December 2, 1971
Bank of Mexico	130	December 2, 1971
Netherlands Bank	300	December 30, 1971
Bank of Norway	200	December 2, 1971
Bank of Sweden	250	December 2, 1971
Swiss National Bank	1,000	December 2, 1971
Bank for International Settlements:		
Dollars against Swiss francs	600	December 2, 1971
Dollars against authorized European currencies other than Swiss francs	1,000	December 2, 1971

Secretary's note: Chairman Burns made the indicated determination on November 30, 1971.

Chairman Burns noted that Mr. Robertson had just returned from a trip to the Far East and invited him to comment.

Mr. Robertson observed that he had visited eight countries. In each he had talked not only with central bankers but also with ministers of finance and other government officials and with private

businessmen and commercial bankers. To start with Japan, he had found serious concern there about recession. The Japanese thought the growth rate would be under 5 per cent this fiscal year, although the official forecast was 5.5 per cent. The government was trying to build confidence that recession had hit bottom. Actually, they thought the trend would continue down through the first half of 1972 unless something was done. The impact of the recession was mainly on imports. October imports were virtually identical with those of October 1970, but exports were up 19 per cent. The recession had cooled interest in investment, and as domestic demand slackened businessmen pushed exports harder.

The yen float had not affected exports so far, Mr. Robertson continued. He had heard reports that export contracts were down, but he had met no one in Japan who thought actual exports had been affected. An official of a major manufacturer of motorcycles had said they had adjusted their prices upward in anticipation of a revaluation of 10 per cent; that official thought the only effect would be to slow down the rate of growth of their export sales. Japanese officials seemed willing to think in terms of a combined yen revaluation-dollar devaluation that would increase the yen value by 15 per cent over the August 15 parity with the dollar. However, businessmen were probably not fully resigned to that. The head of the motorcycle company had said that anything over 10 per cent would hurt sales, and his company was in an exceptionally strong competitive position.

Mr. Robertson remarked that the officials he had seen agreed that yen revaluation would be politically more palatable than import liberalization, especially of agricultural commodities. Agricultural protection in Japan had resulted in some fantastically high prices. Entry of cattle had been liberalized, but a tariff of $130 per head had been applied. As a result, a pound of good beef cost the Tokyo consumer $4 or $5 or more, and one grapefruit cost nearly $1.00. Concern about the impact on Japanese business and agriculture of liberalization of imports and yen revaluation seemed to be considerably greater in some quarters than concern about accumulation of additional dollar reserves. That attitude was clearly reflected in the comments of an official of the Ministry of International Trade and Industry, who seemed to feel that most of the recent reserve accumulation represented the inflow of speculative capital. The Ministry of Finance and the Bank of Japan did not share that view, and they were fully aware of the desirability of effecting a reduction in Japan's balance of payments surplus. However, they showed no interest in reducing Japan's dollar holdings. Because the Sato government was in a weakened condition, it was difficult for them to propose measures to correct their payments imbalance that would stir up opposition in the quarters from which they got their strongest support--agriculture and big business. The easiest course for them was to encourage capital outflow. They

favored loans to institutions such as the World Bank, which did not require budget appropriations.

Mr. Robertson commented that Secretary Connally's tactic of making no specific proposals had the virtue of avoiding the criticism that any realistic proposals would inevitably attract in the Japanese press. On the other hand, the reluctance of the Japanese to make the necessary decisions was producing a state of uncertainty that was not good for business confidence. The Japanese were accustomed to reacting to U.S. initiatives, and they had difficulty in understanding or adjusting to the present approach.

Turning to Southeast Asia, Mr. Robertson said he had found no evidence that any of the countries he visited--Taiwan, Hong Kong, Vietnam, Thailand, and Singapore--was suffering any serious adverse effects as a result of the August 15 measures. The U.S. dollar was still a very highly desired currency. Even in Singapore, which tried to invest its reserves with cold-blooded calculation, the authorities had expressed the view that the dollar should remain a reserve asset currency. The greatest causes of concern were uncertainty about exchange rates and, in some countries, the U.S. textile restrictions and foreign aid policy. There was almost no talk of the surcharge.

Mr. Robertson noted that there was talk of a drop of investor confidence in Taiwan as a result of the United Nation's vote on the admission of Mainland China. Capital was rumored to be

fleeing to Singapore and Hong Kong, but he had found no confirmation of that flight. The Nationalist Chinese authorities were understandably worried about the psychological impact of the U.N. action and they were very unhappy about the U.S. textile quota. They anticipated a decline in their growth rate, which had been over 10 per cent a year.

Mr. Robertson said that Singapore and Hong Kong were outstanding for their prosperity and aggressive growth policies based on maximum encouragement of private investment. Both were heavily dependent on foreign trade, and he had found sentiment strong for an early settlement of the international monetary crisis and a return to fixed exchange rates. The biggest concern was about uncertainty, not about any visible damage to trade that had occurred. Hong Kong was officially very unhappy about the textile quotas, but one of the large manufacturers had told him privately that they could live with the restrictions. The big complaint was that Hong Kong had not been accorded equitable treatment, since it had moved into synthetic fibers only recently and had not developed much of a U.S. market in that field. It therefore had a very small base on which to build.

Vietnam was obviously the poorest of the countries he had visited, Mr. Robertson continued, but the feeling now was that conditions were ripe for economic development. Security was quite

good, and barring another large invasion from the north it was expected to remain so. Thanks largely to a successful interest rate reform--which was first proposed by Federal Reserve economists six years ago--the rate of inflation had been greatly reduced, from around 30 per cent last year to less than 10 per cent this year. Thinking was now in terms of developing the country's productive resources and reducing dependence on foreign aid. Serious handicaps were the inward-looking, protectionist mentality and the overwhelming red-tape of the bureaucracy. That was in sharp contrast with Singapore and Hong Kong.

Mr. Robertson noted that the National Bank of Vietnam might request technical assistance from the Federal Reserve to improve the efficiency of its operations and to cut down on the volume of red tape. He had indicated that the Federal Reserve would do all it could to help. It was encouraging that the top economic positions in the government were now held by young men who were more open to suggestion and more willing to make decisions than their predecessors had been.

Thailand showed evidence of considerable prosperity, Mr. Robertson said. Bangkok was choking in its own traffic. Major problems were declines in foreign exchange earnings as a result of a decline in rice prices and lower earnings from U.S. military expenditures. Thailand held most of its substantial

international reserves in U.S. dollars and was opposed to any devaluation of the dollar. That was because critics had long pressed for gold purchases and they would use an increase in the price of gold to justify their criticism of reserve policies of the Bank of Thailand and the government.

Mr. Robertson remarked that officials in both Australia and New Zealand had exhibited strong interest in an early settlement of the international monetary crisis and a return to fixed exchange rates. Both countries had enjoyed large gains in international reserves in the past year. Both were feeling the effects of uncertainty in economic conditions elsewhere. The Australian stock market was very depressed, having fallen sharply from the very high levels reached last year. Mining stocks, which were influenced by conditions in Japan--the prime market for Australian ores--were particularly depressed. The feeling was that uncertainties about exchange rates and the international monetary system were having an adverse effect on trade prospects.

He had found much concern in both Australia and New Zealand with the control of cost-push inflation, Mr. Robertson observed. New Zealand was trying to enforce wage and price restraint by requiring official approval of wage contracts and prior notification to the government of price increases. A wage board had been established. It would not approve contracts that provided more

than a 7 per cent increase unless there was special justification, such as equity considerations. The labor unions had been threatening to defy the rulings of the board at the time he was in New Zealand. However, the Minister of Finance, who was a strong figure, was confident that the government could win in a showdown. Price control efforts were much less stringent. The New Zealand government felt that prices had to be allowed to rise to cover increased costs, so that the main effort had to be made on the cost side. Australia's compulsory arbitration system had broken down, but the government intended to restore its effectiveness. The breakdown had resulted when the unions defied arbitration court decisions. Fines were levied on the unions, but the government weakly failed to press for payment of the fines. He had been told that the present government intended to correct that situation and insist on payment of fines levied against the unions.

In conclusion, Mr. Robertson said that the one common factor in all the countries visited was the feeling of uncertainty about the future. The reasons were varied, but generally the international monetary situation and the shifts in U.S. policy were the major causes. In addition to the August 15 measures, there were the textile restrictions, the defeat of the foreign aid bill by the Senate, and the shift in China policy. Uncertainty was not conducive to bold business and investment decisions. In his view, what was needed to buoy up economic activity in the Asian area was a clearer indication than was now evident that there was a

grand design behind the disparate policies of the United States that would inspire greater confidence in the future economic and political stability of the Asian area.

Chairman Burns then invited Messrs. Daane and Hayes to report on developments at the recent Basle meeting.

Mr. Daane observed that the meeting had been held on Sunday, November 7. The two main threads of the governors' discussion on Sunday afternoon concerned matters that had already been touched on today--fear of incipient recession and concern over the continuing wage-push inflation. Mr. Brimmer's point that the U.S. policy measures were not the cause of recessionary tendencies abroad was well taken, since fears of a recession had been voiced at Basle as early as the July meeting. Moreover, as Mr. Zijlstra had noted at the latest meeting, the erosion of profits and wage-push inflation clearly had been a source of concern prior to August 15. However, it was the unanimous view of the governors present that the current uncertainties regarding the international monetary situation were an additional and significant factor tending to depress capital investment.

Mr. Daane said he might best convey the flavor of the Sunday afternoon discussion by citing some of the individual statements. The British representative commented on the lag in the effects of the stimulative measures taken in the United Kingdom, and reported that unemployment there had reached the level of one million, or 3.6 per cent of the labor force. The German representative observed

that new orders had fallen off since midyear, and he stressed the role of international uncertainties in that connection. Concern was expressed about the rate of increase in wages in both the United Kingdom and Germany. The Swiss representative reported that despite a continuing shortage of labor he was fearful of a recession resulting from international monetary uncertainties. Although the French representative expressed general satisfaction with the economic situation in his country, he noted that private investors had moved to the sidelines, and he posed the question of whether cost-push inflation and international uncertainties would not adversely affect investment. The Japanese commented on the continuing sluggishness of Japan's economy and expressed considerable concern over the international monetary situation. The Italians said their country was faced with an actual recession, not an incipient one. They expressed concern about cost-push inflation and the international situation. As to the Netherlands, conditions were reported to be generally bad--wage costs had risen 14 per cent over the past year, with only a slight decline in the rate of increase in prospect; economic activity was deteriorating; and unemployment was rising rapidly. The strength of the guilder in foreign exchange markets was described as more illusory than real. With respect to the international monetary situation, the sense of the group could be summed up in a phrase Chairman Burns had used recently--that time was on no one's side in the matter of arriving at a settlement.

He might mention two other matters that were discussed in the afternoon session, Mr. Daane continued. The standing committee on the Euro-dollar market had met on Saturday and an oral report by its chairman, Mr. Larre, was the first item of business on Sunday afternoon. The standing committee had focused on, and reviewed a preliminary report on, central bank swaps with commercial banks. The volume of such swaps outstanding was now $3-1/4 billion, of which more than 80 per cent were Italian and Japanese. The preliminary report did not suggest ruling out such swaps in the future, since they served useful domestic purposes. It did suggest, however, that central banks should take into account their potential impact on other countries, and that an effort should be made to limit their size and duration when it appeared that they could have an undesired effect on the Euro-dollar market. The standing committee also agreed, subject to subsequent approval by the governors, that a further study should be made of possible arrangements to insure that proceeds of such swaps would be channeled to the New York market rather than the Euro-dollar market. A final text of the committee's report would be forwarded shortly to the governors for possible review at a later meeting.

In the area of multilateral surveillance, Mr. Daane observed, the gold and foreign exchange committee had been asked to review regularly the reports now being made on central bank placements in the Euro-dollar market. It was noted that there had been no increase

in central bank placements in the Euro-dollar market since the governors had discontinued their formal commitment not to engage in such placements. Finally, as to the future work of the standing committee, it was agreed that it should turn its attention to questions of commercial bank activity in the Euro-dollar market.

Mr. Daane said he might also mention that the usual quarterly multilateral surveillance report was made by Milton Gilbert. It indicated that in the period from January through August the change in external positions of European countries--an increase of $22 billion--was matched by an outflow from the United States of the same magnitude. From this Mr. Gilbert had concluded, rightly or wrongly, that the Euro-dollar market had played no role in those changes.

At the Sunday night dinner, Mr. Daane continued, President Zijlstra had called for comments on the pros and cons of _de facto_ vs. _de jure_ currency realignments--that is, of setting provisional parities vs. setting declared "permanent" parities under the rules of the International Monetary Fund. The clear consensus of the group was that a return to fixed parities on _de jure_ basis was the only way to eliminate uncertainties. He (Mr. Daane) had made the point that if the realignments were clearly inadequate provisional parities could be necessary. It was generally accepted that there could be no convertibility--whether the realignments were "provisional" or "permanent" so-called--and that they would have to be prepared to accept the currencies of deficit countries for a considerable period to come. It was suggested, however,

that in the meantime some arrangement could perhaps be made to accommodate Fund operations.

Mr. Hayes said he thought Mr. Daane had adequately covered the main developments at the meeting, and he would add only a few footnotes. In agreeing that convertibility could not be restored, the governors were thinking about the next year or so; they did not contemplate the absence of convertibility for the indefinite future. Not only were fears of recession widespread, but some of the central bankers present expressed concern about the political dangers that might be posed by the shaky social structures in many countries if a recession continued for long. The official price of gold had not been discussed in the formal sessions, but several people who brought the matter up in casual conversation had indicated that a change in the price was an absolute must if there was going to be a realignment of exchange rates. Finally, although there was concern about recessionary tendencies in Britain and Germany as well as elsewhere, those two countries were being very cautious about using fiscal policy to offset such tendencies. The British felt that some of the measures already taken would be providing stimulation over the coming year, and that it would be risky to take further measures. The Germans thought that, while a recession might be on the horizon, the tendencies were not yet strong enough to warrant additional fiscal stimulation; in their view, fiscal policy was already quite stimulative.

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

Mr. Partee made the following introductory statement:

Today we present our first economic projection to the Committee extending throughout 1972. We have scaled down somewhat our expectations for this and the next two quarters, since a careful review of the prospects led us to agree with the Committee that we had become a little too exuberant previously. But the outlook for real growth still seems to us quite favorable, and we still expect a meaningful moderation in the pace of inflation and in wage-cost increases, aided by the implementation of Phase II of the economic stabilization program.

In developing our GNP projection, we have been very much aware of the substantial continuing uncertainty surrounding the President's program and the wide range of possible private sector responses to it. Although the policies and initial regulations of the Pay Board and Price Commission have now been announced, it is yet far from clear how the program will operate in practice. Nor is it clear whether there will be enduring widespread public support for the program, or even whether organized labor will continue to participate in Pay Board deliberations; both types of support seem essential to the program's success. Also, business apprehensions about the effects of the program have increased in recent weeks, judging from reports in the red book[1/] and the performance of the stock market; if such apprehensions persist, this could serve to undermine the prospects for vigorous economic recovery.

Nevertheless, we believe that the program will continue to function, and that it has a good chance of making a contribution to the reduction of cost and price

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

pressures. Further, we think that much of the current uncertainty and apprehension is of a transitional nature, and that both business and labor will find it feasible to operate under the wage-price restraint procedures envisioned. We also believe that our projections of nominal GNP, despite substantial acceleration in real growth, do not imply the building up of significant pressures in credit markets, provided that monetary policy permits a prompt return in money growth to the 6 per cent annual rate of the past two years, which our projection assumes. Relative stability in long-term interest rates is thus the likely prospect, at least until late in the forecast period. Finally, we have incorporated some additional fiscal stimulus, on the revenue side, on the assumption of tax cuts along the lines already approved by the House. Federal expenditures are also likely to be a little more stimulative next year, despite the holdbacks in personnel and in some items of expenditure. Total outlays are projected to grow 9-1/2 per cent in calendar 1972, compared with an estimated rise of 8-1/2 per cent in 1971; the larger increase reflects higher social security benefits and the military pay raise associated with the concept of a volunteer army.

Mr. Gramley will begin our analysis today with a review of the current economic situation.

Mr. Gramley made the following comments:

It seems useful to begin with an assessment of how the economic recovery that began late last year has progressed to date. A point of departure is found in a review of developments with respect to industrial production.

Total industrial output--excluding autos and steel, to avoid the distortions of strikes and hedge buying--reached a trough last November, and since then has risen to a level about 2 per cent above a year earlier. Declines in production of business and defense equipment--the two major factors dragging down industrial output since the fall of 1969--have both bottomed out. In fact, output of business equipment has risen in recent months, according to revised data to be published today. A strong and sustained upward thrust from other major sectors of production, however, has been notably absent this year. For example, output of consumer goods, excluding autos, has been rising, but in October was only about 3-1/2 per cent above a year earlier.

Continuation for a while of a relatively moderate growth in industrial activity could well be our lot, judging by the performance of some of the leading indicators. Thus, the

average workweek in manufacturing has risen from its low, but has not yet shown the vigorous rebound that characterized the economic recovery from the 1960-61 recession. Similarly, initial claims for unemployment insurance are below earlier peaks, but the steep descent usually seen in an economy emerging from recession has not occurred. New orders for durable goods, meanwhile, have been comparatively sluggish, particularly in view of the inflation of the dollar figures by rising prices. The rate of net business formation, on the other hand, has risen about as much as it did in the comparable period of the 1961-62 recovery--one of the few leading indicators that has shown much strength this year.

The behavior of industrial production and the leading indicators confirm the widely-held impression that a recovery was indeed under way during the first three quarters of this year, but one that has lacked the energy characteristic of a typical cyclical upturn. But I think it also might be fairly concluded that the prospects for a quickening tempo of economic activity have been increasing over the course of the year.

The probabilities of more rapid growth have been greatly enhanced by the cleanup of excess inventories that has been going on. The stock-sales ratio for retail durables--excluding autos--has declined markedly from the late-1969 peak. This ratio, in fact, is now at its lowest level in over 5 years. Auto inventories are also low relative to present rates of sales. For manufacturers, too, ratios of stocks to sales in lines other than autos, steel, and rubber (where changes have been erratic because of strikes and strike threats) have fallen to about the levels of early 1968.

This improvement in the condition of inventories has not resulted from an actual decline in aggregate stocks, but from conservative inventory policies in a period in which final sales were reasonably well maintained. I think we are approaching the point at which--unless the pace of growth in final sales falters--a rise in the rate of inventory investment will begin to stimulate industrial activity.

The two growing elements of final demand permitting the general improvement in inventory conditions this year have been housing expenditures and consumer outlays for durables. The strength of housing starts is well known; further evidence of that strength is confirmed

by the rise in both starts and permits in October, to be made public later today. Let me say only that the effects of the past runup of starts on general economic activity should continue for some time. Completions lag starts by a considerable margin, especially for multi-family units, and the impact of a revival in housing construction on demand for household durables would be expected to persist even after new housing starts leveled off.

Perhaps less well appreciated is the fact that consumer spending--even after adjustment for price changes--has strengthened measurably over this past year. Total consumer spending in 1958 dollars rose nearly 4 per cent in the year ending in the third quarter of 1971. In the previous year, the increase was less than half that amount. Even more interesting is the changing structure of consumer spending. Demands for durables have risen markedly. A good part of the larger durable goods outlays has been for autos, and some of the resulting stimulus to production was felt abroad. But the rebound in consumer demand for durables has, I think, helped to set the stage for a broader and stronger revival in domestic industrial activity.

Hastening the commencement of a more vigorous rebound was one of the purposes of the President's new program announced in mid-August. Additional fiscal stimulants were a part of the package. Their effects on private spending, however, are hard to judge by traditional measures such as the high employment surplus or deficit. Thus, the import surcharge should bolster domestic demand, even though it increases full employment receipts. Moreover, the auto excise tax removal and the investment tax credit have incentive effects on spending that the high employment budget is not designed to capture. For what it is worth, however, our staff expects the high employment budget to turn moderately more stimulative next year, which should encourage a larger volume of private spending.

It has been widely hoped that the new economic program would also stimulate spending--especially consumer buying--by reducing the expected rate of inflation. Whether there will be a lasting effect of this kind remains to be seen, but recent retail sales data provide room for optimism.

A particularly interesting feature is the recent strength of total retail sales excluding autos. One might have expected that the boom in auto sales would have come

partly at the expense of sales in other lines. In fact, however, retail sales other than for autos have been very strong over the last 3 months.

A substantial amount of attention has been focused in recent weeks on another dimension of the President's program--that is, its effect on the uncertainties of decision-making, particularly for businesses. A major concern of the business community has been the outlook for profits. Profit margins have risen little from the postwar lows reached in 1970. The concern has been that wage-price restraints would fall so heavily on prices that profit margins, and the ratio of prices to unit labor costs, might show little or no improvement.

As we interpret the rules laid down by the Price Commission, however, the base period is defined in a way that would permit an upturn in profit margins and in the ratio of price to unit labor costs. Aggregate corporate profits, therefore, could increase significantly. As this fact becomes more generally understood, we believe that the present hesitancy of businesses to commit themselves to higher production rates, and to greater outlays for inventories and capital goods, will give way to more positive attitudes, and our GNP projection reflects that expectation.

Mr. Wernick presented the following statement on the staff's GNP projection:

Our appraisal of recent developments in key sectors of the economy suggests an appreciable rebound in activity over the next year. The increase in GNP is expected to be larger this quarter than last, mainly because of increased strength in consumer outlays and an improvement in inventory investment as steel liquidation ends. Going into next year, the economy is expected to show more widespread signs of strength and quarterly GNP gains are projected to be significantly larger, averaging about $27 billion. For the year as a whole the nominal increase in GNP is projected to be about 9-1/2 per cent.

If wage and price restraints prove reasonably effective, as we have assumed, a large part of this increase in current-dollar GNP should be reflected in considerable gains in real output. With price increases assumed at around a 3 per cent rate following a post-freeze flurry

of price adjustments, growth in real GNP is expected to average a little over 6 per cent next year. These prospective rates of real growth, although well above long-run potential, are still short of those experienced in previous recovery periods.

Underlying our generally bullish outlook is the expectation that consumers will sustain fairly vigorous levels of spending. In addition to the surge in auto sales in recent months there seems to be increasing evidence that purchases in general merchandise and department stores have also been gaining momentum. Although there is concern that the current high level of auto sales will fall back when price increases are permitted to take effect, we expect that domestic auto sales--though below the September-October pace--will continue at advanced levels throughout next year.

Support for the improved levels of consumer outlays stems in part from fiscal stimulants spread throughout next year, including lower personal taxes, higher social security payments, and military and civilian government pay increases. In addition, more rapid gains in employment and earnings should act to improve consumer confidence and add to spending levels. With demands for autos and household durable goods projected to be strong, the use of consumer credit is likely to be high and the personal saving rate should decline as the year progresses.

Strength in consumer purchases, however, would need to be accompanied by a significant uptrend in business fixed-investment spending if our projection is to be fully realized. So far this year investment spending has been lackluster. In fact, measured in constant dollars, business spending is a little below last year's pace. Nor is there evidence as yet in new orders that any pickup in capital equipment spending is in prospect.

On the positive side, however, business equipment output has begun to turn up and recent private surveys show considerable improvement in anticipated expenditures for plant and equipment in 1972. Most notable is the gain reported for manufacturing industries, where capital expenditures are expected to advance 8 per cent next year compared with a 6 per cent decline in 1971. Our projection assumes increases in business fixed investment about in line with the surveys. These gains, however, are below those in previous cyclical recovery periods, in part reflecting the heavy overhang of unused capacity.

We also feel that the stage has been set for a healthy upturn in inventory investment next year in response to the projected growth in final demands. The rise in inventory investment that we have projected for next year is fairly large; however, it would still fall short of anticipated gains in sales so that the ratio of inventory to sales would continue to trend down. This, in our view, is a relatively conservative projection of potential inventory developments in 1972. If our projection of final demands is realized, prospects would be enhanced for substantial further accumulation later on.

Although residential construction expenditures are expected to remain a strongly supportive influence next year, they are not likely to contribute significantly to aggregate growth. Private starts are expected to reach a peak of 2.2 million units this quarter, with both single- and multi-family starts at record levels. During next year, however, housing starts are expected to edge down to a 2.0 million rate by the fourth quarter.

This projection of a gradually weakening housing sector reflects a belief that demands for non-subsidized apartments will not keep pace with supply, rather than an expectation of a constriction in the availability of mortgage funds. The vacancy rate for rental units has begun to inch up, even though completions of new apartments have not yet increased. As next year unfolds, a rapid rise in the completions rate should serve to increase rental vacancies substantially in many areas. In contrast, single-family starts are likely to continue to rise somewhat further before leveling off late in the year, because of rising incomes and the relatively greater holdback in such building over recent years. Consequently, construction expenditures are expected to moderate in the first half of next year and then to begin a slow decline.

In summary, the economic slowdown has had a much greater impact on industrial production than on total real GNP, largely reflecting weakness in spending for goods by business and the defense establishment. If consumer durable goods outlays continue to strengthen and business expenditures for capital equipment and inventories rise in line with our projections, industrial production should expand at an average quarterly rate of 8.5 per cent over the next year, thus narrowing the gap between real GNP and the production index. This rapid rise in industrial output should result in a considerable strengthening in the demands for labor.

Mr. Zeisel commented as follows on resource use and prices:

With industrial production sluggish over the past few years, employment gains have been concentrated in the nonindustrial sectors of the economy--particularly services and State and local government. While employment increases will likely accelerate in these sectors in the next year, this growth should be accompanied by a resurgence of demand for labor in manufacturing, reflecting rising production of consumer durable goods and business equipment. Some of this need for additional labor will be met by increases in the length of the workweek, but we expect factory employment to rise by about half a million. In contrast, job gains in government are likely to be smaller than they have been recently because of ceilings on Federal employment.

The growth in real output of about 6 per cent projected for 1972 is expected to result in an over-all employment gain of almost 2 million--some 700,000 more than during the past year. We also anticipate a faster rise in the civilian labor force--an increase of approximately 1-1/2 million is projected--close to the so-called "normal" gain representing population growth and trends in participation rates.

With the employment increase expected to exceed labor force growth, we are projecting a decline in the unemployment rate to 5.3 per cent by the fourth quarter of 1972. This is a significant reduction from the 6 per cent rate of the past year, although it still represents a substantial level of unused labor resources.

Continued excess labor resources should operate to ease demand pressures on wage rates and thus support the Phase II program. Some sectors were already showing slower increases in average hourly earnings prior to the freeze, particularly construction, services, and trade. Wages in construction were still rising sharply, however, and are expected to continue up in the post-freeze period at a pace well above the general 5-1/2 per cent Pay Board maximum. In services and trade, on the other hand, wage increases had already slowed to a rate not far above the wage target. While it may be difficult to enforce the Pay Board's rules in these sectors because of the large number of small establishments that are not required to report, the existence of excess available labor should be an important help in holding wage increases down.

In those more heavily unionized industries such as manufacturing, where establishments are larger and where wage increases must be reported by most firms, we assume that the Pay Board's standards will have a significant influence in reducing the average size of new wage settlements. But the slowing will probably not become evident right away because of the large number of deferred wage increases becoming effective in the period immediately following the freeze.

Success in holding down price increases in 1972 should also lead to smaller cost-of-living wage adjustments. Escalator clauses will be included as a part of union contracts covering some 4 million workers by the end of this year. Moreover, Pay Board standards are flexible and could be scaled down as prices moderate.

We expect the rise in compensation per manhour for the private nonfarm economy, including fringes and other benefits, to average about 6 per cent, annual rate, after the initial transition period. This seems broadly consistent with a 5-1/2 per cent target, allowing for deferred increases larger than the standard, and for some tendency for employment to shift to higher-paying industries and jobs. And 6 per cent would be a significant improvement as compared with the 7-1/2 per cent average rate of increase earlier this year.

We also expect an improved productivity performance, accompanying above-average increases in real output. The potential for gains in output per manhour is particularly good in the industrial sector, where productivity tends to respond strongly to increases in output. These gains in over-all productivity combined with a more moderate rise in compensation per manhour should operate to lessen the rate of increase in unit labor costs, and we are projecting a rate of rise for the private nonfarm economy of under 3.0 per cent by the latter half of 1972.

The upsurge expected in manufacturing output and productivity--we expect an annual rate of increase of over 4 per cent in output per manhour--would cut the rise in unit labor costs sharply in this sector. Movements in these costs and in wholesale industrial prices have tended to be generally related, and if our projections of labor costs are realized, the price rise for industrial commodities should be quite moderate next year.

In the consumer sector, less success is expected in moderating prices of services than of commodities. Productivity gains in services tend to be relatively small;

moreover, price increases may be more difficult to monitor. Thus, service prices are not projected to drop below a 4 per cent rate of increase. In the consumer commodity sector, however, where wholesale prices and operating costs should be rising more slowly, Price Commission efforts to limit increases should be relatively successful. The removal of the auto excise tax should more than offset an expected upward adjustment in auto prices. Although food prices may continue upward, increased supplies should limit the pace of the rise, with the large corn crop tending to lower meat prices in the second half of next year.

Reflecting these expected price movements in the industrial and consumer sectors, and even with construction costs continuing to rise at a relatively rapid pace, the GNP private fixed-weight deflator is projected to slow to about a 2-3/4 per cent rate of increase in the last quarter of 1972. This would compare with a rise of over 5 per cent earlier this year.

Mr. Hersey presented the following comments on the balance of payments:

A slowing of inflation in the United States such as has been described would help importantly to get full benefits for U.S. net exports and for the U.S. balance of payments from the exchange rate realignments that have been made and that are yet to come.

Speculation against the dollar in the August crisis produced nearly a $9 billion jump in U.S. liabilities to foreign official reserve holders in a single month. Net private capital outflows, including shifts in the timing of current account payments, must have amounted to about $8 billion in August. For the year to date, through September, they were of the order of magnitude of $20 billion. While much of the speculation and hedging was done by businesses and investors outside the United States, their borrowing of dollars and delaying of dollar payments so as to build up positions in other currencies meant a build-up of U.S. dollar claims on foreigners, in addition to some reduction in U.S. liabilities to private foreigners. Financing the build-up of net claims put pressure on some sectors of U.S. financial markets, as was seen most clearly in the August business loan expansion, while at the same time the market for Treasury bills was being eased by foreign official purchases.

Among the factors that precipitated the crisis was the market's awareness of the deterioration of the U.S. merchandise trade position. Following a relatively good 1970, exports this year may reach $43 billion, but imports may go above $45 billion. From 1963 to 1971, exports have not quite doubled, while imports have increased to 2.7 times the 1963 value. (These value figures for exports and imports reflect price increases of about 25 per cent in each case.)

The percentage growth rate of U.S. imports exceeded that of exports all through the 1950's and 1960's, as foreign capacity for producing and selling finished manufactures expanded. Nevertheless, the trade surplus remained for a long time on a gradually rising trend, at first simply because exports were so much larger than imports, and then because our international competitive position was strengthening in the early 1960's. The downtrend in the trade balance after 1964 reflected adverse changes in the competitive position, as well as such structural factors as Japan's rapidly growing export potential, the automobile marketing agreement with Canada, and rising U.S. needs for petroleum. In the absence of this year's exchange rate adjustments and import surcharge, the trend level of the trade balance would have fallen further next year.

Our projection of the trade balance into the first and second halves of 1972 should be thought of as giving centers of wide ranges. We assume that the exchange rate changes since last May together with the import surcharge--or rate adjustments with equivalent effect--will produce changes in the levels of U.S. exports and imports large enough to raise the trade balance in the second half of next year by something like $4 or $5 billion (annual rate) above what it might have been in the absence of the exchange rate adjustments and the surcharge. But the actual trade balance will fall short of the shifted trend level because cyclical demand factors will be tending to hold it down next year, in sharp contrast to 1970 when there was boom abroad and recession here. Thus, whereas the new trend level of the trade balance might be a moderate surplus in the latter part of 1972, the actual position is more likely to be still in deficit. In 1973 further improvement would be expected, as lags in reactions to the exchange rate changes are overcome. Also, demand abroad might be strengthening in 1973. After the transitional effects of rate changes are completed the

trend line will flatten out, and its slope, up or down, will be influenced by relative price and cost increases here and abroad.

In appraising the significance of the exchange rate changes that have occurred since last May, we find that their effects, as we estimate them, fall a good deal short of what is needed to restore reasonable equilibrium in the U.S. balance of payments. To us it is clear that the present exchange rate structure, even with the addition of more depreciation of the dollar to substitute for the import surcharge, is inadequate. Within this structure the rate for the German mark is relatively high, but the whole structure of rates for other currencies against the dollar is too low. Clearly there is a need for negotiated adjustments to replace the surcharge and to get--and preserve--additional realignments. Under present conditions, with a very large overhang of speculative and hedge positions representing potential demand for dollars, freely floating rates would be unlikely to perform adequately the desired function of stimulating growth of U.S. exports.

The projected improvement next year in the trade balance would be paralleled by a rise in the goods and services balance. In the services accounts, net investments income has improved this year largely because of the lowering of U.S. interest rates, but is not likely to change so much next year. A marked recovery in the balance on current and long-term capital accounts is projected, from something like minus $8 billion this year, but only to minus $5-1/2 billion. For reasonable equilibrium this balance probably needs to be in surplus; to put it there we must count mainly on a further rise in net exports, to be produced by four factors: lagged reactions to past exchange rate changes, further exchange rate changes, a cyclical upswing abroad, and relative cost stability in the United States.

The widened difference this year between the goods and services surplus and the deficit on current and long-term capital accounts is due mainly to a marked shrinkage of private long-term capital inflows to the United States. Net foreign purchases of U.S. stocks, for example, were very small from February to the middle of August. As another example, the inflow of U.S. corporate medium-term borrowing from banks abroad has been considerably less this year than last. The projected decline next year in the net U.S. corporate capital outflow assumes the maintenance

of Office of Foreign Direct Investment restraints in something like their present form. A rapid dismantling of those controls and termination of the interest equalization tax would certainly add further to the need for greater exchange rate adjustments.

I mentioned earlier that trade improvement next year will be held down by demand factors here and abroad. The rise in U.S. activity and incomes will tend to raise imports. Abroad, demand factors particularly relevant for U.S. exports will be weaker in continental Europe next year, where even on a fairly optimistic view, industrial production will be rising only slowly through the first half. Growth in Canada should pick up along with ours. In Britain, policies aimed at expanding consumption are apparently succeeding; doubts about the projected advance in Britain stem principally from fears that international trade may be much less expansive in 1972 than up to now. In Japan, growth of industrial output, which had been strong for four years, very nearly ceased after mid-1970. The Japanese have a big problem of reorienting their future economic growth more toward domestic needs, and it is unclear how rapidly a new rise in activity may develop.

On the European continent, developments in Germany will have an important influence on many countries. It is clear that demand pressures in Germany will be far less intense than they were in 1969 and early 1970, especially for capital goods. Domestic orders for capital goods were relatively flat, in value terms, throughout the first eight months of this year, while export orders bulged and then dropped.

To sum up, unless significant further appreciations of foreign currencies against the dollar are negotiated soon, there is little chance for a U.S. trade surplus in 1972. We may be in an anomalous position. In the absence of a negotiated realignment, we may be still a very long way from achieving a goods and services balance of the size needed for equilibrium in future years, yet at some point during the coming year and for some period of time--it is hard to say when or for how long--we may be experiencing a large unwinding of leads and lags and reflow of short-term funds, probably with a considerable improvement in our net reserve position.

Mr. Partee concluded the presentation with the following comments:

As I stated at the outset, the results of our projection exercise for the year ahead present a broadly favorable outcome. Real GNP growth is expected to accelerate to an average rate somewhat over 6 per cent. Resource utilization is expected to improve gradually, with employment picking up substantially and the unemployment rate approaching 5 per cent by the end of the year. Wage and price pressures are expected to subside, partly reflecting the implementation of Phase II policies but also in response to the continuation of relatively easy labor markets and improving productivity. Profits are expected to increase substantially, partly because of a cyclical recovery in margins--which is consistent with Price Commission guidelines--but mainly because of a higher volume of sales. Even the competitiveness of the United States in foreign trade is expected to show improvement if allowance is made for the adverse impact on the figures of cyclical configurations here and abroad.

The implications of our projection for resource utilization may be judged by the gap between actual and potential output. This gap, as projected, drops from $52 billion (1958 prices) in the third quarter of 1971 to $36 billion by the end of next year. This still represents a 4.3 per cent shortfall from potential output--which is calculated on the basis of a 3.8 per cent unemployment rate--and it might be argued that we should aim at greater progress in closing the gap. Perhaps so, but the potential costs in terms of the additional pressures that might be exerted on the new wage-price restraint machinery should also be taken into account. The collapse of that program would constitute a major and perhaps fatal setback in the effort to dampen inflationary psychology. Also, I would note that the projection shows real GNP still rising considerably faster than potential growth at the close of 1972, so that the implications of a still faster rate of expansion next year for the demand management problems of 1973 could be a cause for concern.

All in all, I am inclined to view the outcome of the projection as reasonably satisfactory. And I think the chances are good that it can be realized. In terms of real activity the expansion that we are projecting is substantial, but not large compared with previous periods of

cyclical recovery. The rate of expansion next year could prove to be more rapid, particularly if business capital expenditures begin a sharp expansion on the basis of improving market expectations and a growing awareness of the benefits of the investment tax credit. Or the recovery could prove more sluggish than projected if consumer sentiment fails to improve as we have assumed it will on the strength of better employment, income, and price trends. In terms of inflation, our relatively favorable assumptions could be upset if new wage bargains significantly and widely exceed the Price Commission's 5-1/2 per cent guideline maximum, or if the whole wage-price restraint apparatus breaks down at an early date. But I would rate the probabilities at present as favoring an outcome close to staff projections with regard to both growth and inflation prospects.

Given the obvious uncertainties that exist at present and are likely to remain for some time to come, however, an appropriate stance for policy would appear to be one that neither risks over-stimulation of an economy that may be moving into high gear nor denies monetary support if we continue to fall short of an adequate recovery. An intermediate stance for policy, in turn, might reasonably be defined as one which encourages a prompt resumption of money growth at about a 6 per cent rate.

We have had some substantial deviations from a 6 per cent path over the past year or so, but the current level of money stock (as revised) is amazingly close to being on a 6 per cent trend line drawn to start in December 1969. If inflation does in fact subside, we should be able over time to reduce the monetary growth target somewhat. But I would not recommend such a shift now; the economy needs to expand considerably faster than it has been doing to date, and there is ample room for increased resource utilization should 6 per cent monetary expansion err a little on the liberal side.

If a 6 per cent path of growth in the narrow money supply is resumed, and if nominal GNP rises as projected, the income velocity of money would increase moderately--by roughly 3 per cent from the fourth quarter of 1971 to the fourth quarter of 1972. Past experience indicates that such a rise in velocity would put some upward pressure on short-term interest rates. Our econometric models, together with our judgmental assessments, suggest that the 90-day Treasury bill rate might increase irregularly

to the 5-1/2 per cent range by the final quarter of next year. Current bill rates are probably at an unrealistically low level in reflection of heavy foreign central bank purchases last August and September.

If our assessment as to the prospective level of short-term rates is roughly on the mark, there would be no reason to expect any substantial diversion in savings flows away from the financial intermediaries. The mortgage market would thus remain in a comparatively comfortable position. Furthermore, for reasons I will discuss shortly, some rise in short-term interest rates in the months ahead would seem consistent with maintenance of long-term market rates near present levels.

The projection of credit flows and how they may be financed that emerges from our GNP projection seems to support an expectation of moderate upward pressure on short-term interest rates next year. Aggregate credit expansion in 1972 is projected to be nearly as large as in 1971--roughly $140 billion in total funds raised. Our estimates of the major sources of these funds suggest that banks would be supplying about the same proportion in 1972 as they have this year; nonbank financial institutions would be supplying somewhat less, since savings inflows to thrift institutions are unlikely to equal the phenomenal 1971 growth rates. But with foreign central banks contributing much less to demands for Treasury securities next year, the share of funds supplied by the private domestic financial sectors (business, individuals, and State and local governments) would have to increase in 1972. Such a development is usually associated with rising interest rates. In this case, however, a good part of the funds so used will be returning from abroad and, in any event, the share supplied by private nonfinancial investors is projected to remain well below that of 1969 or 1966.

Confinement of interest rate pressures mainly to the short-term market is suggested also by our projection of corporate credit needs. The GNP projection implies a further rise next year in corporate gross retained earnings relative to total capital expenditures (defined to include investment in inventories). Consequently, the rate of borrowing should fall off, even after generous allowance for further corporate accumulation of liquid assets. Since external financing in the form of bonds and stocks this past year has been unusually heavy, the decline in total needs for funds is likely to make itself felt

mainly in long-term credit markets. Consequently, we are projecting a significant reduction in corporate capital market financing next year. Long-term interest rates, therefore, are not likely to come under much pressure, especially if inflationary expectations continue to abate.

These projected credit flows--as well as the underlying GNP projection--are based on the assumption that monetary policy will provide for a growth rate of M_1 of about 6 per cent next year. The staff believes that a 6 per cent growth rate of M_1 will develop in the first quarter if money market conditions are eased only a little more than those recently prevailing. This view hinges on the assumption that the recent weak performance of M_1 is due in part to transitory factors. The lagged response of money demand to the decline in market rates of interest since mid-August, together with the possibility of a return of some of the funds sent abroad last summer, should work to raise the growth rate of money in the comparatively near future.

Since I think a 6 per cent growth rate for the narrowly defined money supply is a reasonable policy target for the intermediate term, alternatives A and B seem to me preferable to alternative C.[1/] Of the two, my preference is strongly for B rather than A, in order to put the main emphasis on getting money back on the track of 6 per cent growth relatively soon. We are now in a critical period in which economic and financial decision-making is being clouded by doubts and uncertainties. It would be unfortunate if additional and unnecessary concerns were created as to the System's willingness to return to a moderate path of expansion in the monetary aggregates. I would therefore urge that the Manager be instructed to move promptly to and below the low end of the range specified for the Federal funds rate under alternatives A and B--4-1/2 to 4-7/8 per cent--should this appear needed in order to counter any further unexpected weakness in the aggregates.

Mr. Hayes said he had found today's staff presentation to be an excellent one. He noted that the GNP projections

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

closely paralleled those made by the staff at the New York Bank. Such projections were, of course, based on an optimistic view of the effectiveness of the Phase II price and wage controls, the specifics of which were just coming into focus. And it should be recognized that there were still some basic uncertainties; in particular, consumer and business attitudes had not yet improved to the desired extent and the international financial situation continued to have adverse effects on confidence.

Mr. Eastburn asked Mr. Partee to elaborate on his comment that the probabilities favored an outcome close to the staff's projections. Although his own staff had come up with similar results, he wondered whether the rise in real GNP projected for the next quarter or two was not optimistic. That might be the case if the recent shortfalls in the monetary aggregates reflected weakness in transactions demands for money rather than a decline in precautionary demands.

Mr. Partee responded that, while he thought the GNP growth rate projected four weeks ago had been too optimistic, the lower rate now shown seemed to him to be rather well supported by the decided upturn in consumer spending that was already taking place. It was true that there had not yet been an appreciable increase in production. The exact timing of that

increase depended on how quickly business inventory policies responded to the rise in sales; the projections assumed that substantial rebuilding of stocks would get under way in the first quarter but it could be delayed somewhat if businessmen were apprehensive about the outlook. On the other hand, he expected that sales would be very good during the Christmas season and that resulting shortages would spur fairly prompt increases in the production of many kinds of merchandise. In his view, the projected growth rates fell about in the center of the range of probabilities. As to the reasons for the recent shortfalls in the monetary aggregates, he was not aware of any evidence that suggested weakness in transactions demands. In the Board's model such demands for money were assumed to be a function of retail sales, which had been moving up sharply. Perhaps the unusually low level to which corporate cash balances had fallen reflected the fact that businesses were maintaining speculative positions in foreign currencies.

Mr. Gramley remarked that what information was already available for the fourth quarter suggested that the staff projection was not too high. According to the advance monthly estimate retail sales increased further in October, and the total excluding the automotive group was up 1.2 per cent from September. Industrial production rose .2 per cent in October even though the gain was limited by the coal strike, and housing starts moved back up to an annual rate over two million.

In response to a question by Chairman Burns, Mr. Wernick reported that the upward revisions in the business equipment component of the Board's production index for August and September were partly attributable to equipment other than trucks.

Mr. Kimbrel inquired whether the staff had made any allowance in the projections for the current state of uncertainty and pessimism, especially on the part of businessmen.

Mr. Partee said that in developing the projections the staff had not given appreciable weight to the kind of uncertainty indicated by the recent behavior of the stock market--and reflected in many of the District analyses presented in the red book--because they had no idea how long it might last or how substantial its effects might be. He personally thought the uncertainty would be transitional, and that its effects would take the form mainly of a conservative initial response in inventory policies to expansion in sales. If such a pattern were sufficiently marked, it might result in a lower rate of inventory accumulation in the fourth quarter than the projections indicated.

Mr. Kimbrel asked whether there was anything the Federal Reserve could do to lessen the prevailing uncertainty.

Mr. Partee said he would expect attitudes to improve as the public became more confident about the workings of the Pay

Board and Price Commission. However, it appeared that the views some people held about the future were beginning to be affected by the continuing stream of weak money supply numbers. To the extent that was the case, the System could contribute to greater confidence by insuring that the money supply began to grow again.

Mr. Maisel said he would like to have the staff comment on two technical issues, the first of which related to the outlook for productivity and unemployment. Compared with most of the studies he had seen, the staff's projection of the rise in output per manhour over the coming year--given the expected rate of growth of output--was low. If the projection was too low, the gap between actual and potential GNP at the end of the projection period would be greater, and the unemployment rate higher, than indicated; and Mr. Partee's warning that faster growth might exert undue pressure on the machinery for wage-price restraint might not be warranted.

Mr. Zeisel noted that in the projection an increase in real GNP at a rate of about 6 per cent was associated with a rise in output per manhour for the nonfarm economy of about 3-1/4 to 3-1/2 per cent. Productivity was expected to advance somewhat faster in manufacturing--by about 4 to 4-1/2 per cent--but more slowly in services and trade. He believed that the over-all rate of increase shown would fall within the range of forecasts that would be yielded by econometric models, and that it was not an unreasonable expectation.

Mr. Maisel then remarked that the second--and perhaps more important--technical issue concerned the likelihood that a 6 per cent growth rate in money in 1972 would prove consistent with relatively stable long-term interest rates, as Mr. Partee's concluding comments implied. An analysis involving GNP and retail sales figures for almost any period during the past five or six years would suggest that the growth rate in money would have to be on the order of 8 or 9 per cent, rather than 6 per cent, if long-term interest rates were to remain stable while dollar GNP was rising at a rate of about 9-1/2 per cent.

In reply, Mr. Gramley said he might first note that interest rates were extremely difficult to project and that the staff would not assign very high probabilities to the projections it had made. However, those projections were consistent with the results of both judgmental and econometric procedures and they appeared reasonable to him. The money demand function in the Board's large-scale model--and also that in the monthly money market model--indicated that there would be a relatively small increase in interest rates if the income velocity of money rose at about a 3 per cent rate. The large-scale model suggested that such an increase in velocity normally would be associated with a rise in 3-month bill rates of about 10 per cent, or roughly 50 basis points. However, the bill rate at present was unusually low relative to other short-term rates as a result of recent

heavy foreign official demands, and it was therefore projected to rise to about 5-1/2 per cent by the end of 1972.

Chairman Burns asked whether the econometric and judgmental projections were reasonably independent.

Mr. Partee replied that the two sets of projections were made independently by different groups of people. After the results were compared, the judgmental results often were modified on the basis of the econometric projections.

Mr. Partee then said he might underscore Mr. Gramley's comment on the difficulties of making interest rate projections, particularly at this time. It was quite possible that a rate of monetary expansion more rapid than 6 per cent would be required if upward pressures on long-term rates were to be avoided. However, there were some special factors that might keep rates from rising. First, inflation premiums might decline a little further if, in fact, prices increased no more than projected. Secondly, corporate demands on the long-term bond market, which had been very large, should be reduced as the need for funds from external sources declined. Third, it appeared that the demand for mortgage funds had already reached its peak and would not be continuing to rise in 1972. Finally, there might be some return flow of the funds that had been shifted into foreign currencies. The reduction in foreign central bank investments in

dollar assets and the concurrent increases in private investments would tend to put some upward pressure on short-term rates--especially bill rates--and some downward pressure on long-term rates, thus narrowing the spread. Altogether, it appeared to him that long-term rates could be stable or could even decline somewhat next year even if bill rates rose by 100 basis points.

In response to a question by Chairman Burns, Mr. Gramley said it had been assumed in the projections that in calendar 1972 the Federal deficit would be $31 billion on a unified budget basis, and $26-1/2 billion on a national income accounts basis. Those figures were somewhat higher than the present estimates for calendar 1971.

Mr. Mitchell said he shared Mr. Maisel's doubts with respect to the projection that a 6 per cent rate of growth in M_1 would prove consistent with expansion in dollar GNP at a 9-1/2 per cent rate. Looking back over the present year, no one had foreseen the very rapid growth in M_1 which occurred in the period from February through July, and which apparently was explained by a sharp rise in the demand for money on the part of individuals. Subsequently M_1 had not grown at all on balance. In view of the highly variable experience over the course of 1971 he saw no reason to sanctify a 6 per cent growth rate at this point. If there were large changes in money demands over the next year, as there might well be, maintaining a 6 per cent rate of growth in M_1 could have highly undesirable consequences.

Mr. Partee replied that the staff had not meant to sanctify any particular growth rate of M_1. At present a 6 per cent rate appeared to be a reasonable target for early 1972, but it should be noted that little information was available as yet on the Administration's budget for the next fiscal year. The staff would be reevaluating the outlook over coming months, and it would be quite prepared to recommend a higher target rate for growth in M_1 if that appeared warranted.

Mr. Coldwell remarked that the staff projection seemed to be based on an assumption that the post-freeze stabilization program would be effective. He had serious doubts on that score, in light of the possibility that actions by the Pay Board and Price Commission approving some increases and denying others would be viewed as inequitable. If the public were to lose confidence in the fairness of those groups the whole control effort might break down, with severe damage to the objective of dampening inflationary expectations. Unless there were an improvement in confidence he would not expect businessmen to take the initiatives that would be needed if the staff's GNP projections were to be realized.

Mr. Mayo observed that there was a distinct cleavage at present between the majority of economists, who expected 1972 to be a fairly good year, and people in the business and financial community, who were quite pessimistic. Personally, he thought

the staff projection would be realized. That there would be inequities in the control program had been recognized from the start, and businessmen generally were prepared to live with a measure of uncertainty. The current pessimism, he thought, was a consequence of the very great number of uncertainties involved in the transition from Phase I to Phase II. He was hopeful that those uncertainties would be resolved over the next few weeks as the shape of the system of controls emerged from decisions of the Pay Board and the Price Commission. If the confusion became greater, of course, pessimism would deepen and GNP no doubt would expand less than the projections indicated.

Mr. Mayo then said he might comment briefly on why the auto companies had failed to raise output schedules thus far despite the very high level of sales. He understood that they were unwilling to expand their work force beyond a level they felt sure they could maintain throughout 1972, because they were sensitive to cost factors and to the unfavorable publicity that results from layoffs.

Chairman Burns remarked that such reasoning would suggest a lack of confidence in the sales outlook for next year, and Mr. Mayo agreed.

Mr. Swan said he agreed with Mr. Partee's statement in the staff presentation that interest rate behavior probably would not induce a substantial diversion of savings flows away from

the thrift institutions. Noting the emphasis on M_1 in the discussion thus far, he inquired about the likely course of the broader monetary aggregates.

In reply, Mr. Partee said the rate of increase in time deposits at commercial banks, which was 22 per cent in the first half of this year, was projected to decline to 10 per cent in the second half and to remain in a range of 10 to 12 per cent in both halves of 1972. Inflows to the nonbank savings institutions were projected to decline in the second half of this year from the very high rate in the first half and then to edge down gradually next year. Those projections were based on the income and savings implications of the GNP projection and on the assumptions about interest rate developments. Accordingly, they became increasingly uncertain as more distant periods were considered. Should interest rates rise in the second half of 1972, the inflows would decline, although with some lag.

Mr. Morris commented that the staff projections of GNP were higher than any he was aware of by economists in the Boston area. Although they were not necessarily wrong, he did not agree that they were at the midpoint of the range of probabilities. In particular, he thought it was unlikely that economic activity would accelerate as rapidly in the current quarter and in the first quarter of next year as the projections indicated.

With respect to production schedules for automobiles, Mr. Morris said he could confirm Mr. Mayo's observation on the basis of a conversation he had had last week with representatives of one of the major auto companies. They reported that the industry was interpreting the recent strength in sales cautiously, in view of the possibility that it was a temporary surge reflecting expectations of higher prices. As a result, they had not raised production schedules. They were reluctant not only to expand employment but also to increase overtime operations because of the higher costs involved. If that should be the response of business generally, economic activity would not rise as rapidly in this quarter and the next as projected by the staff, and growth in the monetary aggregates would fall short of the rates desired. He thought the Committee should be especially alert over the next few months to signs that growth in the aggregates was failing to come up to expectations.

Mr. Brimmer suggested that before the next meeting of the Committee the staff might consider the possibility that the projected rate of growth in productivity was too low, and explore the implications of a faster rate. If the rise in productivity had been underestimated, there might in fact be virtually no real improvement in the unemployment situation, especially with the prospective release of 300,000 men from the military forces. And if, as Mr. Morris had suggested, the odds favored slower

growth in real GNP than projected, one might ask whether there was not a need for more expansive policies. Any such need might well have to be met by monetary policy since it appeared that nondefense Government spending would show only normal growth and not reflect any new programs.

Mr. Partee observed that the projections of Federal spending allowed for increases in military pay and social security benefits and for the expected end of the decline in defense spending. It was true that no major new programs in the domestic area were contemplated.

Mr. Gramley said the staff recognized that if their projections of the rise in output per manhour were wrong they were more likely to be too low than too high. However, if one was concerned primarily about economic weakness in the near term, monetary policy was not the ideal instrument to provide additional stimulus because of the lags in its effects.

Mr. Maisel observed that he had made some calculations of the GNP gap that would result if growth in output per manhour was faster than the staff assumed. The calculations suggested the gap would be between $60 and $70 billion for the year 1972 and between $45 and $50 billion in the last quarter.

Mr. Partee commented that, because productivity changes had consequences for both unit labor costs and unemployment, the staff had considered the outlook in that area with particular

care. He did not know how the projections could be further refined; whether they understated the rise that would actually occur was a matter of judgment. It was worth noting that even if the projections turned out to be correct there would still be a substantial volume of unused resources in the fourth quarter of 1972. Accordingly, he would agree that in making policy it would be better to have any errors fall on the side of more rather than less stimulation.

Chairman Burns said he would like to underscore Mr. Partee's point about unused resources. According to the staff's estimates, even if the projections of productivity proved valid unemployment would still be at the rather high rate of 5.3 per cent in the fourth quarter of 1972.

The Chairman then said he might note that the present discrepancy between the thinking of economists and businessmen was wider than any he could recall in the corresponding stage of previous business cycles. By and large, economists were working with models of one kind or another and they were relying heavily on lead-lag analyses. Businessmen, on the other hand, were troubled by a number of new--and very real--sources of uncertainty. The first was the program of wage and price controls. No matter how confident one might be about the ultimate success of those controls, one could not ignore the fact that at present

they were creating uncertainty and hesitation in the business community. Many businessmen were unable to reconcile the guideline of 5-1/2 per cent for wage increases with that of 2-1/2 per cent for prices; they understood imperfectly the arithmetic relating changes in wages, productivity, prices, and profits. That source of uncertainty was likely to persist for some time.

Secondly, the Chairman said, the unsettled international financial situation was proving to be a much greater source of uncertainty than he, for one, had anticipated. Apparently, large American corporations had become heavily involved in foreign operations that recently had proved far more profitable than their domestic operations. Now they sensed the possible onset of recession abroad and a shrinkage of profits from foreign operations. Altogether, the prospect of decline in cash flow from abroad, the fact that domestic interest rates were still relatively high, and the widespread fear that the Price Commission would be tougher in its rulings than the Pay Board must have been retarding expansion in business investment outlays.

Another source of uncertainty, the Chairman observed, concerned the actions Congress might take on taxes--a concern that appeared to be well-grounded as one watched the progress of the tax bill in the Senate. That Federal deficits were large and would remain so was worrisome to businessmen. Also, concern had

been growing of late about the recent behavior of the money supply. That concern was not widespread as yet, but it would intensify if the staff projections of increases in short-term interest rates were borne out. Many business and financial people had been a little confused recently by the combination of lack of growth in the money supply and declining interest rates. If money supply should continue to show no growth while interest rates turned up, uncertainty would be increased.

Chairman Burns said there was no question in his mind that over the years economists had been more nearly right in their assessments of the outlook than businessmen, and he thought they would prove to be so on this occasion as well. However, he had less confidence on that score than in the past, because of the new and very real factors of uncertainty that now were so prominent in the thinking of business and financial people.

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 October 19 through November 10, 1971, and a supplemental report covering the period November 11 through 15, 1971. Copies of both reports have been placed in the files of the Committee.

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

System open market operations sought gradually to ease money market conditions over the period since the Committee last met in light of the apparent weakness in the narrow money supply, and of the tendency of other interest rates to decline. Bond markets were generally characterized by an optimistic tone over most of the period although there was some hesitation from time to time as inventories piled up in dealer hands. Towards the close of the period there was considerable evidence of congestion, particularly in the municipal bond market. The equity market was quite soft as market participants seemed substantially less optimistic about the future of the economy than the professional forecasts. Although details of Phase II of the new economic program are becoming available, uncertainties remain, with many market participants apparently feeling that price restraints are apt to be tougher than wage restraints with adverse consequences on business profits. Moreover, market participants--in bond as well as equity markets--appear quite fearful--perhaps overly so--about the likelihood of recession abroad with an attendant depressing impact on the domestic economy.

As many have noted, there has perhaps never been a wider discrepancy between market attitudes and standard economic forecasts. Uncertainties can be resolved only as the success of Phase II is measured week by week and as new economic developments, at home and abroad, provide a clearer picture of where the economy is headed. Some evidence of progress in working out a solution to the international situation could be most helpful in allaying market apprehensions.

Short-term interest rates generally declined by 1/2 point or so over the period, roughly in parallel to the two 1/4 point cuts in the prime rate. The reduction in the discount rate last week was generally considered in the market to be a confirmation of market rate movements and came as no surprise. In yesterday's regular Treasury bill auction, average rates of 4.12 and 4.25 per cent were established for three- and six-month bills, down over 35 basis points from rates in the auction just before the last Committee meeting.

The Treasury was active over the period, with its regular quarterly refunding carried on amid a buoyant atmosphere in the Government securities market. Public response to the offering of a 7-year note by the Treasury

was heavy, but subscriptions to the 15-year bond were meager, emphasizing the fact that redeveloping an active market in long-term Government debt will require a great deal of effort. Following the refunding, the Treasury sold at auction a $2-3/4 billion, 15-month note to cover attrition in the refunding and to raise about $1-1/2 billion in new money. Dealer awards of all three new issues--particularly of the short note where the absence of tax and loan account privileges restricted bank bidding--were large, and positions in coupon issues rose to an all-time high of $3.1 billion. At the close of business last Friday, dealers still held $1,971 million of the three new issues, having made net sales of $255 million. The Treasury will have to raise about $5-1/2 billion in new money by year-end, presumably through the auction of tax bills with the first auction expected to be announced in a few days. Even keel considerations should be minimal.

Open market operations, as noted earlier, sought progressively less firm money market conditions. While at the close of the period we were seeking a Federal funds rate at the lower end of the 4-3/4 to 5-3/8 per cent range indicated as appropriate by the Committee at the last meeting, we were cautious in day-to-day operations not to appear overly aggressive to the market in order to avoid adding encouragement to speculative forces operating in the market. Outright market activity by the System Account was in fact relatively light over much of the period, involving the sale of about $250 million short-term Treasury bills early in the period and the purchase of $83 million agency issues later on. Yesterday, in light of reserve needs ahead, the System purchased $248 million Treasury coupon securities. Repurchase agreements and matched-sale purchase transactions were used on several occasions to take care of temporary reserve aberrations.

Looking ahead, there is considerable uncertainty about the reserve estimates over the week ahead, reflecting doubts about the level of the Treasury balance and a more optimistic outlook in New York than at the Board for growth in deposits. On balance it looks like a substantial reserve supply will be needed involving significant outright purchases, including more Treasury coupon issues (of which there is a plentiful supply) and some

agency issues. But obviously the way the Desk approaches day-to-day operations will have to depend on how the projections turn out.

Desk operations will also depend, of course, on the Committee's choice of a directive today and the specifications that it decides to attach to it. As the Committee knows, M_1 has been relatively weak for several months, although--given the rapid growth early in the year--it was up nearly 7 per cent in October from the year-ago figure. As the blue book[1/] indicates, the Board's staff is projecting a further small decline at a 1 per cent annual rate in November; New York projections indicate the resumption of growth at a modest 2 per cent annual rate. M_2 and the credit proxy, both of which showed moderate growth rates in October, although somewhat below the blue book path, are projected to grow somewhat more rapidly in November with New York estimates indicating a more rapid expansion than the blue book numbers. While the measure of the narrow money supply has been weak recently, there appears to be no collateral evidence of a shortage of money or liquidity at financial institutions or in the economy as a whole--nor is there evidence of any lack of credit availability.

It thus, once again, becomes a question first of how much the Committee wants to focus on M_1 as a guide to operations as compared to the broader measures of the money supply and to bank credit, which have been behaving more reasonably; and second, how far and how fast the Committee wants to ease money market conditions in order to achieve its aggregate objectives. Alternative C calls for an aggressive approach that would almost certainly evoke early expectations of a further reduction in the discount rate. Alternatives A and B--and the possible variants under them--are closer to the more cautious--but accommodative--approach that the System has been following in the recent past.

One further matter in which the Committee may be interested: We are planning to add three new names to the list of dealers that formally report their activity to the Federal Reserve--the Bank of America, A.G. Becker and Co., and John Nuveen and Co. All three have expressed the desire to become dealers and have been informally

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

> reporting to us for some time. The Bank of America has already established that it is capable of making markets and can be helpful to us in our operations, and we plan to add it to the list of dealers with whom we do business. The other two have in the past three months increased their activity and each now accounts for about 1 per cent of total dealer activity. This appears sufficient to add them to the formal reporting list--which we feel should be the case of any firm that accounts for a significant share of the total market--but we will defer a decision to deal with them until they have improved certain aspects of their activity. We also plan to talk to another dealer whose activity has tailed off, and if the firm cannot improve its operations over time we will consider dropping it from the list.

In response to a question by Chairman Burns, Mr. Holmes said there were no reasons other than a declining volume of activity for considering the possibility of dropping the firm he had referred to from the list of dealers with whom the Desk did business.

The Chairman then asked whether any harm would result from keeping small dealers on the list even if their activity declined.

Mr. Holmes replied that, while such a course would do no harm in general, there would seem to be little purpose in keeping a firm on the list if its activity dropped off to the point at which it was practically out of business as a dealer. He had referred to the firm in question because the volume of its operations had declined sharply in recent months and now was very low. As he had indicated, however, he planned to talk with the firm. It was quite likely that its activity would pick up again.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 19 through November 15, 1971, were approved, ratified, and confirmed.

Mr. Axilrod then made the following statement on the monetary relationships discussed in the blue book:

The policy alternatives presented to the Committee seem straight-forward. Alternative A places primary stress on money market conditions, and by extension on interest rates, while alternatives B and C continue to emphasize monetary aggregates. In our view there are good reasons for continuing to emphasize the aggregates in open market strategy. As explained in the blue book, we believe that a period of unusual fluctuation in the demand for money has largely been completed and that a return to more normal growth of money demanded in relation to income is in prospect in the not too distant future. As evidence, though perhaps overly simplified, we might take the downward drift of the money stock since August as having just about offset the excessive portion of the rise, viewed in longer-run terms, of spring and early summer.

On this assumption, the stage would be set for an effort by the Committee to begin supplying an amount of reserves and money more in keeping with what might be considered the longer-run needs of the desired expansion in GNP. As the Committee did so, if growth in demand for goods and services fell short of expectations, interest rates would decline, setting in motion forces to counteract the weakness in goods demand, and vice-versa should GNP tend to grow more rapidly than anticipated.

Against this background, if the Committee decides to continue placing primary stress on the aggregates, one particular point affecting the interpretation of the directive and operations might be emphasized. The money market conditions shown in the blue book as consistent with a particular aggregate path represent the staff's best initial estimate of a day-to-day operating target, given the forecast for growth in nominal GNP. The range of fluctuation noted for, say, the Federal funds rate is meant to be a rough indication of the range in which the rate might fluctuate and be consistent with

> the path for the aggregates. If the aggregates in fact were turning out stronger or weaker than desired, the logic of the approach would suggest that the whole Federal funds target rate range of fluctuation be moved up or down. For instance, if the Committee were to adopt alternative B, and the aggregates in fact fell short of specifications, the staff does not mean to indicate that a 4-1/2 per cent funds rate--the lower end of the range--would put them back on target. We would say that the average funds rate would probably have to be lower than 4-1/2 per cent.
>
> Of course, there are always a number of economic and financial conditions that determine the Committee's decision as to trade-offs between aggregates and interest rates. Under current circumstances, the Committee might consider suggesting that the Desk deliberately move to the lower end of the alternative B money market range even if the aggregates are on or slightly above path, if such a move were necessary to offset upward pressures on interest rates over the next few weeks that may arise from seasonal pressures on short-term markets and a sizable overhang of unsold securities in long-term markets. The relatively weak performance of the aggregates expected over the balance of November and in December, particularly in the context of the substantial shortfalls of the past three months, would seem to provide scope for such a balancing of aggregate and interest rate objectives.

Chairman Burns referred to Mr. Axilrod's comment that the target range for the Federal funds rate might be modified if the aggregates were turning out stronger or weaker than desired. He asked how early in the coming period the Manager would be able to make a judgment on that question.

Mr. Axilrod replied that some relevant evidence would be at hand tomorrow when the first firm estimates became available for the previous statement week, which ended November 10. At the moment, only rough estimates were available for that week. Equivalent rough

estimates for the current week, ending tomorrow, would be available on Thursday. If tomorrow's figures indicated that the aggregates were deviating significantly from the desired path, the Manager presumably would decide between beginning immediately to alter money market conditions or delaying action in the hope that the current deviation would be offset by deviations in the opposite direction in later weeks.

The Chairman then said he would be interested in how the staff would propose to have the term "significant deviation" interpreted. He noted, for example, that under all of the alternatives M_1 was projected to decline at an annual rate of 1 per cent in November. If it appeared that M_1 was actually growing at, say, a 3 per cent rate, would the staff suggest that the Desk should seek money market conditions near the firmer end of the specified range?

Mr. Partee said that in his judgment a deviation of 4 percentage points, as in the Chairman's example, would be sufficiently large to call for some response by the Desk unless the Committee had specified otherwise.

Chairman Burns said he would not favor firming action in those circumstances, since a 3 per cent growth rate for M_1 would be subnormal.

Mr. Daane asked whether the Desk's response should not be influenced by whether the other key aggregates--M_2 and the bank credit proxy--continued to run above path.

Mr. Partee said he assumed the Committee would want the Desk to take the behavior of those aggregates into account. However, it was not his impression that M_2 and the proxy series were appreciably higher than contemplated at the October meeting.

Mr. Axilrod noted that the preliminary estimates currently available for the week ending November 10 indicated that M_2 and the credit proxy were about $800 million and $100 million, respectively, above their projected paths. However, in the immediately preceding weeks and on average in October both had been below path.

Mr. Brimmer observed that in early 1971 the Committee had sought to make up for the shortfall in M_1 that had occurred in the fourth quarter of 1970 as a result of the strike in the automobile industry. As it turned out, during the spring and early summer M_1 had grown far more than desired. He asked whether there now was a danger of repeating that pattern.

In reply, Mr. Axilrod said that if M_1 showed zero growth in the fourth quarter, as projected under alternatives A and B, an effort to compensate in the first quarter by seeking a growth rate of, say, 12 per cent would probably result in downward pressure on interest rates sufficiently great to cause control problems later. Accordingly, he would not recommend that the Committee deliberately attempt to compensate for the current weakness in M_1. What the staff was proposing, essentially, was that the Committee consider

the fourth-quarter behavior of M_1 as a stage of transition to the resumption of more normal growth next year.

Chairman Burns then called for the go-around of comments on monetary policy and the directive, beginning with Mr. Hayes who made the following statement:

Although Phase II has started off in a way to justify restrained optimism, there are still major uncertainties in the outlook both with respect to inflationary expectations and with respect to the pace of real economic growth. The international situation is of course adding to the uncertainty. Under these circumstances, and with fiscal policy highly stimulative and tending to become more so, monetary policy must continue a very cautious stance. Thus, I think we should accommodate somewhat lower market interest rates if the latter seem attributable to reduced inflationary expectations or sluggish business developments and slow business loan demand; and we should encourage moderate growth of the aggregates, measured over a reasonably extended period. But we should not, in my judgment, push for lower interest rates; nor should we be unduly concerned over the negative growth rates for the narrow money supply for two or three months, granted that a return to moderate growth would be desirable fairly soon. One reason for my lack of concern over the recent shortfall in M_1 is the fact that the broader money supply and the credit proxy have been expanding satisfactorily, and it seems to be widely conceded that the economy is in no sense lacking for adequate liquidity.

Appropriately enough, last week's reduction in the discount rate by most of the Reserve Banks appears to have been viewed widely as a flexible adjustment to market interest rates and not as an aggressive signal of additional ease. I would assume that our directors will fall into line with the new rate at our regular meeting later this week.

To my mind the specifics of open market policy for the next four weeks should remain roughly where

> they have been, with some modification in the target range for Federal funds to reflect the lower discount rate. I would hope that the funds rate would be at or a little above the discount rate most of the time, though I would not be troubled by an occasional dip below it. I would be fearful that a funds rate pretty consistently below the discount rate would lead to undesirable expectations of another discount rate cut in the near future. Bank borrowings of $100 to $300 million and a marginal reserve position of around $100 million free reserves to $150 million net borrowed would also seem appropriate.
>
> As for the directive, I like alternative B but would not expect the Manager to be quite as sensitive to movements away from the paths for the aggregates as the text of the blue book would suggest.

Chairman Burns referred to Mr. Hayes' comment that the Committee need not be unduly concerned about negative growth in M_1 for two or three months. Since he (the Chairman) did not attach any significance to the difference between a small positive and a small negative figure, he preferred to think in terms of the period for which growth was subnormal rather than negative. Allowing for the low growth rate of August and the decline projected for November, it appeared that growth in M_1 had been subnormal for four months.

Mr. Morris said that like Mr. Hayes he supported alternative B, but for somewhat different reasons. He thought the rates of growth in the aggregates that would be recorded for 1971 as a whole would be appropriate, despite the subnormal growth of recent months. It would be unfortunate, however, if the recent subnormal behavior was permitted to continue. Accordingly, he believed that for the next few months the Committee should focus somewhat more

closely than it had at recent meetings on the objective of generating faster expansion. The risk of continuing subnormal growth rates was particularly great if, as he thought, the staff's near-term economic projections were overly optimistic, and if the Committee relied on the relations between interest rates and rates of expansion in aggregates that were implied by those projections in deciding on its money market specifications.

In his judgment, Mr. Morris continued, the range for the Federal funds rate associated with alternative B in the blue book--4-1/2 to 4-7/8 per cent--was too narrow. Even under Mr. Axilrod's interpretation of the blue book ranges, he would prefer to specify initially a wider range for the funds rate--namely, 4-1/4 to 4-7/8 per cent.

Mr. Coldwell remarked that his thinking today was influenced by the fact that if the Phase II controls on wages and prices proved to be ineffective and if fiscal policy was going to be stimulative the entire burden of stabilization would fall on monetary policy. In his judgment there was adequate liquidity for the current level of business activity, and he thought there would not be much improvement in over-all activity until some of the various uncertainties existing at present were resolved. A modest rate of credit growth would be appropriate during the period in which conditions were settling down and fundamental forces were strengthening the economy.

Mr. Coldwell said he favored alternative A for the directive, on the grounds that it would be desirable at present to place limits on both increases and declines in interest rates. He would suggest a range of 4-1/4 to 5 per cent for the Federal funds rate. He would like to see some small positive growth in the aggregates in December, and he would not want to make a commitment at this time to a first-quarter growth rate in M_1 of 6 or 8 per cent.

Mr. Swan expressed the view that some expansion in the aggregates was needed over the rest of the year. Accordingly, he favored a directive along the lines of alternative B, and he agreed with Mr. Morris that the lower limit of the range specified for the funds rate should be reduced to 4-1/4 per cent. Also, he would like to have the Manager react promptly in the event the aggregates were falling below the projected paths, but not if they were exceeding those paths by a moderate amount.

Mr. Swan then said he had two changes to suggest in the language of alternative B for the second paragraph of the directive and one change in the draft of the first paragraph. First, the statement in B that the Committee "seeks to achieve moderate growth" in monetary and credit aggregates had been employed in other recent directives during a period in which M_1 was actually declining. He believed it would be desirable now to shift to some such language as "seeks to promote moderately increased growth." Secondly, in

view of the many prevailing uncertainties he thought it would be difficult to make a decision at this time about the growth rates in the aggregates that would be appropriate for the first quarter of 1972. For that reason it might be desirable to limit the time horizon of the statement about objectives for the aggregates by replacing the phrase "over the months ahead" with "over the rest of the year." With respect to the first paragraph, he would prefer to delete the word "temporarily" from the statement that "The U.S. foreign trade balance was temporarily raised in September...." That word implied a forecast for later months, and it was unnecessary because the rest of the sentence explained that the September improvement was a result of expectations of a port strike.

Chairman Burns suggested that the Committee resolve at this point the question Mr. Swan had raised about the statement in the first paragraph regarding the foreign trade balance. After discussion, it was agreed that the word "temporarily" should be omitted.

Mr. MacLaury said he had two brief comments on methodological matters. First, in the current blue book the staff had followed its recent practice of proposing policy alternatives that involved completely discrete ranges for the Federal funds rate. All too often that practice resulted in making at least one of the alternatives unrealistic; it would be better, he thought,

to set forth alternatives that involved some overlap in the suggested specifications. His second point concerned the statement in the blue book that if the Committee adopted a directive with a primary instruction formulated in terms of the aggregates rather than money market conditions "it presumably will want the Desk to be more sensitive to movements away from the paths in the aggregates...." He saw no necessary reason for such a presumption; the Committee could call for just as much sensitivity to deviations in the aggregates under the proviso clause of a directive with a money market orientation as under one formulated in terms of the aggregates.

With respect to policy, Mr. MacLaury continued, his views were quite close to those of Mr. Morris. He favored alternative B for the directive, with the wider range for the funds rate the latter had suggested. In general, he would like to see the Desk continue its recent practice of following market rates down but not pressing aggressively toward lower rates.

Mr. Mayo expressed the view that the Committee was tending to focus too narrowly on the level of the Federal funds rate as the measure of money market conditions and on the behavior of M_1 as the measure of the performance of the aggregates. Such a tendency on the part of the Committee encouraged market participants and the financial press to concentrate unduly on those variables as indicators of the stance of policy, and that had undesirable consequences.

While he could accept alternative B for the directive, Mr. Mayo observed, he preferred A. He would specify a range for the Federal funds rate even broader than that Mr. Morris had suggested--perhaps 4-1/4 to 5 per cent--and he thought that in assessing money market conditions the Desk should take account of the whole gamut of measures, including the Treasury bill rate, and not just the Federal funds rate. With respect to the aggregates, account should be taken of the behavior of M_2, the bank credit proxy, and total reserves; it was important to note that the recent behavior of those aggregates had been somewhat different from that of M_1.

Mr. Clay observed that there was cause for concern in the continuing shortfall in projected growth of the financial aggregates. Accordingly, he thought the Committee should move toward some moderate improvement in the growth patterns of those variables. However, it would not appear wise to move strongly, lest in the process such action might lead to another period of excessive growth in the aggregates.

On the whole, Mr. Clay continued, the performance of the money and capital markets continued to be highly constructive. A similar performance in the weeks ahead would be a desirable development. The Federal Reserve should not aggressively pursue lower interest rates. The program of being receptive to lower yields in the money and capital markets continued to be the proper course.

Alternative B appeared to be the appropriate choice for the directive today, Mr. Clay said. While the specifications given in

the blue book for A and B were the same, under present circumstances he considered the format of B to be preferable.

Mr. Heflin remarked that he was particularly impressed with the comments in the red book relating to the state of confidence in the business and financial communities, which documented the Chairman's appraisal of the present divergence between the thinking of businessmen and economists. He believed that policy over the next few weeks should be directed at resisting any further erosion of confidence and at preventing further declines in the aggregates. Accordingly, he favored alternative B for the directive, with the wider range for the funds rate suggested by Mr. Morris.

Mr. Mitchell referred to the Chairman's observation that economists had a better forecasting record than businessmen, and said he could clearly recall some occasions in recent years on which economists, including the Committee's staff, had been wrong. At present, however, he thought the staff projections were right and that business sentiment would shift. That led him to reject alternative C for the directive; he could accept either A or B, but preferred A. He had no objection to widening the range for the funds rate. He thought action should be taken more promptly to correct shortfalls in the aggregates than to correct upward deviations.

Mr. Daane remarked that a vigorous recovery in economic activity still lay in the future, and uncertainties about both

Phase II and the international financial situation were having adverse effects on confidence. For those reasons, he thought monetary policy should become somewhat more accommodative at present. To his mind, none of the directive alternatives submitted by the staff captured the flavor of the policy stance he considered appropriate. He preferred a directive formulated in terms of money market conditions, but he thought the language of alternative A--calling for "maintaining the money market conditions that have evolved since the discount rate reduction"--had undesirable connotations of holding to the status quo. Since he was impressed with the need for the System to do more than passively accept economic recovery when it came, he would favor a directive calling for the maintenance of "accommodative" money market conditions.

Mr. Daane added that he agreed completely with Mr. Mayo's comments about the undesirability of equating money market conditions with the Federal funds rate and equating the aggregates with M_1. On the latter score, he would remind the Committee that in the first three quarters of 1971 M_2 increased at annual rates of 18, 12-1/2, and 4-1/2 per cent, respectively, and the bank credit proxy at rates of 11, 6-1/2, and 9 per cent. While their growth rates were not high in October, according to the latest staff estimates both aggregates were slightly above path in early November. In his judgment, Mr. Swan's proposal for the directive--to say that the Committee "seeks to promote moderately increased growth"--would

be appropriate if the Committee were focusing exclusively on M_1--but not if it intended to have M_2 and the credit proxy also taken into account, as he thought it should.

Mr. Maisel said he thought it was clear that most of those who had spoken in the go-around thus far would not be satisfied with a passive acceptance of weak behavior in the monetary aggregates. It was true that the growth path for M_2 shown in the blue book under alternatives A and B was slightly above that associated with the directive the Committee had adopted at its previous meeting. However, the new paths for M_1 and the bank credit proxy were considerably below those of four weeks ago; and in his opinion the earlier paths for all three aggregates were too low.

Mr. Maisel went on to say that he favored alternative B for the directive today, although like Mr. Swan he would modify the description of the Committee's objective for the aggregates. He thought the Committee's intent would be most clearly expressed by language indicating that it sought "to promote greater growth" in monetary and credit aggregates. And he would stress a point which seemed to be implicit in the comments of others--that the Committee was concerned with the behavior of interest rates and interest rate expectations over the period ahead, and that it would like to see an upward movement of rates avoided if at all possible. He agreed with Mr. Morris that the specified range for the Federal funds rate should be widened. However, he thought the Desk should aim

immediately for a funds rate of 4-1/2 per cent, which probably would be associated with a slightly positive level of free reserves. Subsequently, the target should be reduced to 4-1/4 per cent if interest rates were showing a tendency to rise, or if the aggregates were falling below their target paths.

Mr. Brimmer said he shared the view that the Committee had been placing excessive emphasis on M_1 and the Federal funds rate. While he would like to see the aggregates grow somewhat faster than they had recently, he would not want to go as far as called for under alternative C. He favored alternative B, modified to indicate that the Committee sought "greater growth in monetary and credit aggregates" over the months ahead. He agreed that the range specified for the funds rate should be widened to 4-1/4 to 4-7/8 per cent.

Mr. Winn expressed the view that monetary policy had not been contributing to the underlying state of pessimism in the business community. In view of the likelihood that the fiscal measures enacted by Congress would be more stimulative than the Administration had proposed, he would not be eager to see monetary policy move aggressively to a more stimulative stance at this time. He would continue the present posture of policy, along the lines suggested by Mr. Mayo.

Mr. Eastburn remarked that he preferred alternative B for the directive, with the wider range for the funds rate others had suggested.

Mr. Kimbrel said he also subscribed to alternative B, and would reduce the lower end of the range specified for the funds rate, possibly to 4-1/4 or 4 per cent.

Mr. Leonard observed that views at the St. Louis Reserve Bank were in concert with those of the Board's staff with respect both to the economic outlook and appropriate monetary policy. He added that in the interest of time he would summarize the statement on policy that he had prepared and submit the full text for inclusion in the record.

Mr. Leonard then summarized the following statement:

> Beyond the contribution of Price Commissions, Pay Boards, Cost-of-Living Councils, and other control measures, it is monetary and fiscal developments that hold the key to economic stabilization. With the aid of the new program, monetary policy has a real opportunity to reduce inflation more quickly. It is our feeling that good monetary policy can assure the success of the Phase II program, so that controls can be phased out within a relatively short time.
>
> In our opinion, monetary actions in recent months have been consistent with the new economic program. Market interest rates have drifted lower in response to a downward revision in inflationary expectations and an apparent decline in loan demand because of greater uncertainty. We feel that System actions may have dampened the decline in rates, since the key Federal funds rate has decreased less than some other rates. The marked slowing in growth rates of monetary aggregates since mid-August has offset a portion of the undesirable spurt of last spring and early summer.
>
> As for the near future, we prefer the language of the current policy directive with its emphasis on achieving moderate growth rates of the monetary aggregates (alternative B). The moderate 4 per cent rate of growth of M_1 between now and next March that this policy specifies seems appropriate to us. In view of a possible further reduction in inflaticnary expectations and the current uncertainty and anxiety among businessmen, a further

slight easing of market conditions about in line with the specifications of alternative B appears to be developing. But market conditions may vary considerably in a time of great uncertainty. The current directive (which we favored at the last meeting) specified bank reserve and money market conditions consistent with moderate growth in the monetary and credit aggregates. As I understand it, this directive contemplated an increase in total reserves, while in fact we suffered a decline in total reserves. In view of this, we would prefer placing most emphasis on total member bank reserves in policy implementation, as the Maisel committee on the directive proposed, and giving the Federal funds rate a sufficiently broad range within which to fluctuate.

Mr. Robertson made the following statement:

Viewing this country from a more distant perspective than usual, the strongest single impression that strikes me concerning the economy is that of deep and persisting business and consumer uncertainty. To be sure, announcements have been made of the apparatus to be utilized for post-freeze economic stabilization policy. But uncertainty is still strong in many minds compounded of an inability to perceive how the new mechanisms will operate, and skepticism that they actually will work as envisioned. Uncertainty on the domestic front has been aggravated by the hesitancy exhibited by international businessmen, who are themselves very unsure of the international exchange situation.

Such uncertainty has manifested itself in cautious business and consumer spending commitments, slack loan demand, and disappointing stock market conditions. It is not surprising that such reactions have been accompanied by downward drifting interest rates.

In such an environment, we must recognize the possibility that any unexpected major development could trigger exaggerated changes in business and consumer attitudes. No such development is known to be in the offing, but the possibility of overly exaggerated responses to unanticipated circumstances should lead us toward cautious policy actions.

In light of this situation, I think that we should pursue the goal of a gradual, orderly increase in the supply of reserves on somewhat more liberal terms than heretofore. We should expect money market conditions to ease in this process, and additionally this approach may help move the aggregates back up to more positive rates of growth.

> Our staff projections have given us some encouragement that these hoped-for objectives will result from a policy such as that just recommended. I believe the directive language most suggestive of this approach is alternative B of the staff's drafts.

Mr. Robertson added that he liked the modification of alternative B suggested by Mr. Swan, and he certainly agreed that the range specified for the Federal funds rate should be widened. He also agreed that account should be taken of all of the key aggregates, and not just M_1. It seemed to him that that was contemplated by the reference in alternative B to "monetary and credit aggregates."

Chairman Burns said he shared the view that the Committee should take greater account of the behavior of M_2 than it had been recently. At the same time, he would not want to place much emphasis on the bank credit proxy since he thought its significance for purposes of monetary policy was limited.

Like others, the Chairman remarked, he had been eager to see the earlier explosive rates of growth in the monetary aggregates come to an end, and he was pleased that that had now been achieved. However, it was important to avoid overdoing the slowdown. As he had already noted, weakness in the aggregates was beginning to be an independent source of uncertainty in the economy, and to prolong the period of low or negative growth rates would contribute to that tendency. Accordingly, he preferred alternative B for the directive today, and he definitely favored reducing the lower end of the range for the Federal funds rate to the neighborhood of 4-1/4 per cent.

By and large, the Chairman continued, the sentiment of the Committee appeared to be in favor of alternative B, with a 4-1/4 to 4-7/8 per cent range specified for the Federal funds rate and with the understanding that the Manager would move more promptly to counter shortfalls in the aggregates than upward deviations from the expected paths.

The Committee then proceeded to discuss the various proposals that had been made for changes in the language of alternative B. At the conclusion of the discussion it was agreed that the directive should indicate that "...the Committee seeks to promote somewhat greater growth in monetary and credit aggregates over the months ahead."

> 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:

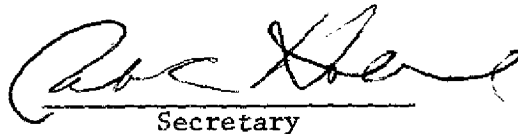
> The information reviewed at this meeting indicates that real output of goods and services expanded modestly in the third quarter, but greater growth appears in prospect for the current quarter. Although the unemployment rate has declined recently, it remains high. Available data indicate that the 90-day freeze effectively limited increases in prices and wages, and basic policies for the post-freeze stabilization program have been announced. The narrowly defined money stock declined further in October, but inflows of consumer-type time and savings deposits to banks expanded considerably and the broadly defined money stock increased moderately. Expansion in the bank credit proxy slowed substantially as the volume of large-denomination CD's outstanding rose less than in September and as U.S. Government deposits were reduced.

Interest rates on both short- and long-term market securities have continued to decline in recent weeks and Federal Reserve discount rates were reduced by one-quarter of a percentage point to 4-3/4 per cent. The U.S. foreign trade balance was raised in September by a sharp acceleration of export shipments in advance of an East Coast port strike. In recent weeks net outflows of short-term capital apparently have diminished further, market exchange rates for foreign currencies against the dollar on average have not changed much, and foreign official reserve holdings have increased less than they did in September. 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 promote somewhat greater 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.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, December 14, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

Attachment A

November 15, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 16, 1971

FIRST PARAGRAPH

The information reviewed at this meeting indicates that real output of goods and services expanded modestly in the third quarter, but greater growth appears in prospect for the current quarter. Although the unemployment rate has declined recently, it remains high. Available data indicate that the 90-day freeze effectively limited increases in prices and wages, and basic policies for the post-freeze stabilization program have been announced. The narrowly defined money stock declined further in October, but inflows of consumer-type time and savings deposits to banks expanded considerably and the broadly defined money stock increased moderately. Expansion in the bank credit proxy slowed substantially as the volume of large-denomination CD's outstanding rose less than in September and as U.S. Government deposits were reduced. Interest rates on both short- and long-term market securities have continued to decline in recent weeks and Federal Reserve discount rates were reduced by one-quarter of a percentage point to 4-3/4 per cent. The U.S. foreign trade balance was temporarily raised in September by a sharp acceleration of export shipments in advance of an East Coast port strike. In recent weeks net outflows of short-term capital apparently have diminished further, market exchange rates for foreign currencies against the dollar on average have not changed much, and foreign official reserve holdings have increased less than they did in September. 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 the money market conditions that have evolved since the discount rate reduction; provided that somewhat easier conditions shall be sought if it appears that the monetary and credit aggregates are falling significantly below the growth paths expected.