MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, September 19, 1972, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Bucher
Mr. Coldwell
Mr. Daane
Mr. Eastburn
Mr. MacLaury
Mr. Mitchell
Mr. Robertson
Mr. Sheehan
Mr. Winn[1/]

Messrs. Francis, Heflin, and Mayo, Alternate Members of the Federal Open Market Committee

Messrs. Morris, Kimbrel, and Clay, Presidents of the Federal Reserve Banks of Boston, Atlanta, and Kansas City, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Solomon, Economist (International Finance)
Messrs. Boehne, Bryant, Gramley, Green, Hersey, Hocter, Kareken, and Link, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

1/ Left the meeting at the point indicated.

Mr. Coyne, Special Assistant to the Board of Governors
Mr. Reynolds, Associate Director, Division of International Finance, Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, Adviser, Division of International Finance, Board of Governors
Mr. Struble, Economist, Division of Research and Statistics, Board of Governors
Mrs. Sherman, Secretary, Office of the Secretary, Board of Governors

Mr. Merritt, First Vice President, Federal Reserve Bank of San Francisco
Messrs. Eisenmenger, Parthemos, Taylor, Scheld, Andersen, Tow, and Craven, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, St. Louis, Kansas City, and San Francisco, respectively
Mr. Cooper, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on July 18, 1972, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on July 18, 1972, 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 August 15 through September 13, 1972, and a supplemental report covering the period September 14 through 18, 1972. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs observed that since the last meeting of the Committee, the dollar had strengthened further against most of the European currencies, with reflows of short-term funds from Europe apparently offsetting deficits elsewhere in the U.S. balance of payments. The market had seemed to be discounting any important or disturbing developments at the forthcoming IMF meeting. The recent sharp decline in the London gold price, reflecting rumors of impending Russian sales, an adverse turn in the South African balance of payments, and German rejection of any gold price increase, had also helped to relieve market anxieties. During the past week, the payments balance also seemed to have benefited from some covering of short positions against the dollar taken 3 months ago at the time of the sterling crisis. Finally, the possibility of new intervention by the Federal Reserve was very much in the minds of market traders.

Shortly after the last meeting, Mr. Coombs said, the System sold roughly $10 million of German marks to consolidate the improvement of the dollar against that currency, and it had not done anything more in marks since then. The System also phased out its intervention in Belgian francs, and the franc subsequently remained

well below its ceiling. Since then the System had been accumulating both Swiss francs and German marks through modest day-to-day purchases whenever market conditions were favorable, and it had built up Swiss franc balances to the equivalent of $23.5 million, and mark balances to the equivalent of $60 million.

At the last meeting, Mr. Coombs noted, he had recommended that a tentative proposal from Mr. Leutwiler, of the Swiss National Bank, to effect a sizable reduction in the System's Swiss franc swap debt through joint forward operations by the Federal Reserve and the Swiss National Bank, be referred to the Subcommittee. Unfortunately, Mr. Leutwiler's proposal was not approved by the President of the Swiss National Bank, Dr. Stopper, on the latter's return from vacation. If and when the uncovered dollar position of the Swiss National Bank was reduced to somewhat lower levels, the Leutwiler proposal might be revived, but for the time being it was stalled.

Looking to the future, Mr. Coombs observed that with every month that passed the trend of U.S. trade figures would probably increasingly influence market psychology. If the figures published in the current or following month indicated a decided improvement, the return flow of funds from Europe might suddenly jump to heavy proportions. On the other hand, he saw a major risk that continuing speculation on a revaluation of the Japanese yen might tend to

enlarge further the U.S. trade deficit with Japan, canceling out possible improvement elsewhere and thereby leaving a false impression of a general overvaluation of the dollar. On the other hand, market psychology would also be strongly influenced over coming months by the success or failure of the Western European governments in dealing with inflationary pressures which seemed to be gathering additional force. At present, market opinion was inclined to believe that the United States would do better than Europe in controlling inflation and thereby gradually improve its competitive position.

Finally, Mr. Coombs commented that the Common Market faced a major political and technical problem in repairing the damage inflicted on its monetary unification project by the sterling crisis and the speculative problems associated with the "snake in the tunnel." For the time being, the threat of joint floating or other joint defensive action against the dollar had receded, and the potential weakness of individual currencies was being more closely scrutinized. Over the next few months, therefore, a good many cross-currents might appear in the market and might call for a fairly flexible policy response.

By unanimous vote, the System open market transactions in foreign currencies during the period August 15 through September 18, 1972, were approved, ratified, and confirmed.

Mr. Coombs then reported that 4 System drawings on the National Bank of Belgium, totaling $110 million, would mature for the fifth, sixth, or seventh time in the period from October 3 to October 27. The System would endeavor to repay the drawings as they matured. If the Belgian franc continued to weaken, it might be possible to buy some francs in the market. However, he would not want to push the franc rate back to its ceiling, which would undo much of the benefit that had resulted from the System's intervention in the market. In addition, it might be possible to negotiate with the German Federal Bank and the Belgian National Bank to use some of the System's holdings of marks in repayment of its debt in francs, although that was a kind of operation that he would not want to engage in very often. If it proved to be impossible to accumulate sufficient Belgian francs to repay the drawings, there would be no alternative to renewing them.

In reply to a question by Chairman Burns, Mr. Coombs said the System could not buy francs directly from the Belgian National Bank with dollars at this time. The Belgians took the position that the Smithsonian Agreement obligated them to buy dollars only at the ceiling rate; they were likely to maintain as well that they would buy only in the market and not directly from other central banks. Although they also were eager to have the swap debts repaid,

they believed, as he did, that it was better to wait for a safer opportunity.

Mr. Daane remarked that at the meeting of central bank Governors in Basle over the preceding weekend, a number of governors --and the Belgian Governor, in particular--had complimented the System on its operations in the foreign exchange markets.

Chairman Burns remarked that he wished to express the Committee's appreciation to the Manager for his conduct of recent operations.

> By unanimous vote, renewal for further periods of 3 months of the 4 System drawings on the National Bank of Belgium maturing in the period October 3-27, 1972, was authorized.

Chairman Burns then invited Mr. Daane to report on developments at the meeting in Basle on the weekend of September 9-10.

Mr. Daane remarked that to save time, he would submit a statement for the record[1/] and abstract from that statement the two or three items most relevant to Committee policy. First, the Basle meeting was quiet and uneventful, and hopefully that foreshadowed a similarly quiet and noncontroversial annual meeting of the International Bank and International Monetary Fund, which was to be held in Washington during the week beginning on September 24. Second, the European governors, looking toward a meeting of their own to be held on the day after the Basle meeting, were preoccupied

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1/ Mr. Daane's statement is appended to this memorandum as Attachment C.

with their own problems of actual or incipient inflation and the potential role of monetary policy in dealing with those problems. They were worried about rapid rates of monetary expansion in their own countries--most notably in the United Kingdom--and were searching for methods of controlling the money stock. Finally, there was considerable discussion of central bank activities in the Euro-dollar market, in view of the German Finance Minister's proposal--incorporated in his economic program--that central banks withdraw funds from the market. The Standing Committee on the Euro-currency Market was charged with the task of taking a fresh look at the question and at the related one of the possibility of an attractive, alternative investment outlet in the United States--either a "money-employed account" at the Federal Reserve Bank of New York or a new Treasury instrument. The latter was discussed with a view toward also utilizing any such instrument to attract central bank funds of non-Group of Ten countries.

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

Mr. Gramley made the following statement:

> At the last meeting of the Committee, Mr. Partee called attention to evidence that the pace of expansion in real activity had slowed over the late spring and summer months. Since then, industrial output and employment have shown signs of some strengthening. Both manufacturing and total nonfarm payroll employment rose considerably in August, and the length of the factory workweek increased. Gains in industrial output last

month were widespread by industry groupings; the 1/2 percentage point increase in the index was the largest since April, and estimated production levels in June and July were revised up a shade.

This recent pickup in the tempo of industrial activity, however, still leaves us well below the track of last spring's rapid gains in real output and employment. Manufacturing employment in August was only a little higher than in May, and new hires in manufacturing have not regained the rates seen earlier this year. Industrial production from May to August rose only about one-third as rapidly as in the previous 3 months. Rates of increase have been appreciably slower for most major categories of industrial output--defense equipment being the notable exception.

Some persisting effects of the June floods may still be reflected in these figures, but that could explain only a small part of the recent moderation in real growth. The more fundamental factors seem to be the leveling out of activity in residential construction--though we learned late yesterday that housing starts rose appreciably in August--and the continued cautious policies of businesses with regard to inventory accumulation. Nowhere have these cautious attitudes been more evident than in the auto industry. In June and July total business inventory accumulation was held down by declining auto inventories at retail, and in August stocks of domestic units fell further, to a 44-day supply at August sales rates--the smallest supply relative to sales in 5 years. But in other lines, too, stocks have been permitted to decline in relation to sales; in fact, the aggregate stock-sales ratio for manufacturing and trade firms is now down to its lowest level since about mid-1966.

Despite the recent lull in the rate of economic expansion, our staff view of the outlook has not been altered appreciably. Some moderation from the unusually rapid pace early this year was to be expected and, indeed, welcomed. And there is reason to anticipate a return to rather vigorous expansion in the months ahead.

Consumer spending has continued to be very strong; August retail sales recorded another 1-1/2 per cent increase, following a rise of nearly 2 per cent in July. And the mood of retailers--as conveyed, for example, by

the red book[1]--suggests widespread optimism about near-term trends in consumer buying. Domestic new car sales did fall significantly in the first 10 days of September, but this may be explained partly by the low level of stocks and the absence of efforts to sell 1973 models before the formal introduction date.

The outlook for business fixed capital spending also continues favorable. Manufacturers' new capital appropriations rose again in the second quarter, and new orders for nondefense capital goods were unchanged in July at a level 11 per cent above the first-quarter monthly average. The latest Commerce survey reduced slightly the increase in anticipated plant and equipment outlays for the year 1972, but the reduction was in estimated expenditures during the second quarter. A substantial rise is now expected in the second half of this year, whereas little had been anticipated in the May survey.

Turning briefly to wages and prices, recent developments have been disappointing, even though not unexpected. Average wage-rate increases in July and August were more substantial, following a very tranquil period from April through June. Since January, however, the annual rate of increase in average hourly earnings is still only about 4-3/4 per cent. The rapid rise in wholesale prices in July and August and the acceleration in the rise of the consumer price index in July were more disheartening. It is small comfort that the largest increases have been mainly among commodities whose prices are volatile. Unfortunately, with prices, what goes up need not come down.

Looking ahead, our staff projection for the fourth quarter of 1972 and for the year 1973 is for somewhat larger increases in nominal GNP than the projection a month ago. Real growth is expected to be large enough to reduce unemployment to under 5 per cent by the fourth quarter of next year, but the projected annual growth rate of real output still decelerates to around 4-1/4 per cent by that time. The rate of increase in prices

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

is also expected to be a little higher than previously projected, especially in the latter half of next year. By the fourth quarter of 1973, the fixed-weight deflator for private GNP is projected to be rising at about a 4-1/2 per cent annual rate.

Let me remind the Committee that our price projection reflects an assumption made last June--to which we have held--that the wage-price control program would terminate in April. How much better we could do if some form of controls were retained would depend very much on the nature of the controls.

Our current GNP projection reflects, among other things, the more expansive monetary policy assumed for the latter half of this year. Based on figures available a few weeks ago, we projected growth in M_1 at about a 9 per cent rate in the current quarter and 7 per cent in the fourth--in contrast to the previous assumption of 6 per cent growth in the second half of this year. This change adds about 1 per cent to the stock of money by the end of 1972. In 1973, we assume a 6 per cent growth rate for M_1, as we had before.

The collective staff judgment is that the marginal effects of a 1 per cent increase in the stock of money would be relatively small--in terms of both real activity and prices. This seems to me reasonable. Housing and State and local construction are usually the principal sectors that respond to easier credit conditions. But there is no great backlog of demands in either sector to exploit now, so that aggregate demand would be less likely to respond sensitively to easier monetary policy.

Having said this, I would hasten to add that current growth rates of the monetary aggregates, and rates of inflow of deposits to the nonbank intermediaries, seem to me too high for comfort. There is still room for greater resource utilization in the economy, but the degree of slack seems likely to diminish as time goes on, and the degree of pressure on wages and prices to intensify. To be sure, substantial uncertainty exists as to how actual events will unfold next year. Economic growth may fall short of what we have projected. But I believe the probability is just as great that demands for goods and services may be larger than we now foresee. If that judgment is correct, there are increasing risks in pursuing a course of monetary policy that results in growth of money and credit at the advanced rates that now seem in prospect for the second half of this year.

Mr. MacLaury asked Mr. Gramley how much the assumption that wage and price controls would end in April--rather than continue in their present form--affected the projection of the GNP deflator for 1973.

In reply, Mr. Gramley said that last June, in preparing projections for 1973, the staff had made the assumption that controls would not be extended beyond April for two reasons: it saw no indications of Administration or Congressional pressure for extension of the authorizing legislation, and it thought the projections of price developments in an assumed environment without controls would be useful to the Committee. At that time, Mr. Partee had expressed the judgment that termination of the controls by April 1973 would add a few tenths of a percentage point to the rise in prices over the balance of the year, and he (Mr. Gramley) saw no reason to question that appraisal. He believed that an effective program of controls could hold the rate of increase in prices throughout 1973 below that projected by the staff.

Mr. Gramley added that estimation of the effects of a continuation of controls during 1973 was very much a matter of judgment; the econometric model gave very little help in formulating answers. One had to make judgments about both the form the controls would take and their effectiveness. After controls

had been introduced in August 1971, the staff had made such judgments in preparing its projections for 1972. So far this year, actual behavior of wages and prices had been better than projected, but one could not say how much of the difference between actual and projected behavior was attributable to market forces and how much to the controls.

Mr. Hayes commented that he, like Mr. Gramley, was impressed with the continuing strength of the economy. In general, the New York Bank's projections of economic activity were similar to those presented by the Board's staff. He was somewhat encouraged by the recent behavior of wages and of consumer prices other than those for foods. He was discouraged, however, by the outlook for prices. In particular, he was concerned about the rise in food prices and its likely effect on wage demands in the period ahead. Moreover, after 2 years of slack in economic activity, inflation was still a serious problem. That raised distressing prospects for the course of prices as rates of resource use rose in the coming year, especially if high rates were approached rapidly.

Against that background, Mr. Hayes continued, he regarded the Government's fiscal situation as crucial and disturbing. He was not optimistic about the success of the Administration's efforts to limit Federal spending, and he foresaw the possibility of the recurrence of a rapid expansion in such spending--comparable to

that in the 1965-68 period--at a time when inflation was already a problem.

Mr. Hayes added that at a recent meeting of business executives, he had been impressed by an almost unanimous expectation that inflation would be worse next year. There was general and strong support for retention of wage and price controls next year.

Mr. Sheehan observed that staff projections in the green book[1/] suggested to him that rates of resource use would not rise rapidly next year. He asked Mr. Gramley to comment on the projections.

Mr. Gramley noted that the unemployment rate was projected to decline to 4.8 per cent by the fourth quarter of 1973; the rate for men aged 25 and over would be in a range of 2-1/4 to 2-1/2 per cent, which was about the rate prevailing in late 1969 and early 1970. The rate of capacity utilization in manufacturing would rise to around 81 per cent. In his judgment, demand pressures on wage rates would begin to develop under those circumstances. The projected figures on capacity utilization did not suggest that commodity prices generally would be subjected to demand pressures, but prices had

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

been rising and were likely to continue upward if economic activity expanded along the lines projected.

Mr. Hayes remarked that he had read with interest a First National City Bank analysis of the relationship between the rate of unemployment and the behavior of prices. Their "Phillips curve" suggested that the equilibrium rate of unemployment was 5-1/4 per cent; a rate lower than that would accelerate the rate of increase in prices.

Mr. MacLaury asked whether the unemployment rate for men aged 25 and over had fallen below the range of 2-1/4 to 2-1/2 per cent during the preceding business upswing, and what the over-all rate of unemployment had been at that time.

Mr. Gramley replied that the rate for men aged 25 and over passed through the 2-1/4 to 2-1/2 per cent range while the over-all rate was 3-3/4 to 4-1/4 per cent. If one used the rate for that particular group as a standard, labor markets had been tighter in earlier periods than was being projected for late 1973. For example, the rate had been below 2 per cent in 1968 and early 1969.

Mr. Heflin observed that the tone of the red book prepared for this meeting was generally optimistic. In his own District, members of the Richmond Bank's board of directors were as bullish as he had ever known them to be. Economic activity was expanding

rapidly and labor shortages were beginning to appear; industry in the Carolinas was actively recruiting labor from outside the District. The directors generally were concerned about the labor situation in prospect for the year ahead, believing that it might prove to be like the one in 1970, and they all strongly favored continuation of wage and price controls.

Mr. Heflin added that in view of the tone of the red book, he was surprised that the staff had lowered the third-quarter projection of real growth. He sometimes wondered whether the staff adequately took into account the materials prepared for the red book.

Mr. Gramley replied that the staff studied the red book carefully and found it a very useful document. With respect to the projections, the third quarter had been revised down very slightly on the basis of production and employment data for July and August; unexpectedly large increases in September would have been required to reach the third-quarter rate of growth that had been projected a month earlier. However, projections of growth in real GNP for the period from the fourth quarter of this year through the fourth quarter of 1973 had been raised on balance by about a half of one percentage point per quarter.

Mr. Mitchell noted that staff projections suggested a sizable rise in inventory investment. He asked whether inventories

had been performing as projected earlier and what the consequences for economic activity would be if such investment did not rise significantly further.

In reply, Mr. Gramley said a failure of inventory investment to rise further from the second-quarter rate certainly would make a great deal of difference in the rate of economic expansion. However, such a performance for inventories in combination with the projected behavior of final sales would result in a steep decline in the inventory-sales ratio. As it was, the staff projections implied a further decline in the over-all ratio from about 1.50 recently to about 1.46 by the middle of 1973 before it leveled out. Such a performance was roughly the same as in the comparable period of the business upswing that began in 1961.

Mr. Daane noted that the staff projections were based on an assumption of growth in the monetary aggregates in 1973 consistent with a 6 per cent rate of growth in M_1, and he asked what impact higher rates of growth would have. He also asked whether the effects of alternative fiscal policies did not need to be considered.

In reply, Mr. Gramley said the staff had run experiments with the econometric model to evaluate, without any judgmental refinements, the effects of both higher and lower rates of monetary growth next year. A 7 per cent rate of growth in M_1 throughout

1973 resulted in additional growth by the fourth quarter of next year of about $4 billion in nominal GNP from a base of around $1,200 billion in the fourth quarter of this year; a step-up to an 8 per cent rate of growth in M_1 would add, roughly, another $4 billion. The consequences of monetary growth rates lower than 6 per cent in 1973 would be roughly symmetrical. However, the full effects of the higher or lower rates of monetary growth would not be felt within 1973 but would be spread over a longer period. The unrefined results of the model suggested that, during the first year, a higher rate of monetary growth would have its major impact on real GNP; the effect on prices was moderate.

Continuing, Mr. Gramley said the staff had not made comparable experiments with fiscal policy. However, fiscal policy also was a powerful tool, and it affected economic activity with a somewhat shorter lag than did monetary policy.

Mr. Eastburn commented that projections made at the Philadelphia Bank suggested that with growth in M_1 at a 5-1/2 per cent rate, the GNP deflator would rise at an annual rate of 3.9 per cent in the fourth quarter of 1973, whereas with growth in M_1 at 9 per cent, the deflator would rise at a rate of 4.2 per cent. The unemployment rate in the fourth quarter of next year would be 4.8 per cent with the slower monetary growth and 4.2 per cent with the faster monetary growth. The differential

effects of the assumed rates of monetary growth on the behavior of the deflator and the unemployment rate were not great in 1973 but would be greater later on.

Mr. Gramley observed that most econometric models based on data for the period since the Second World War had long lags in the adjustment of prices to changes in the rate of monetary growth. The Board's model, and many others, suggested that increased monetary growth eventually was reflected almost entirely in the rate of increase in prices and very little in the rate of real growth.

Mr. Morris said he had heard recently that the House Ways and Means Committee was likely to approve a ceiling of around $250 billion on Federal expenditures for fiscal 1973. He asked whether the staff had tried to evaluate the impact that such a ceiling would have on economic developments in 1973.

Mr. Gramley replied that the staff had not attempted to do so in a formal way. However, staff projections currently suggested that Federal outlays would reach $257 billion in fiscal 1973, and a cutback effected over the remainder of the fiscal year to stay within a ceiling of $250 billion could have major effects on the course of economic activity.

Chairman Burns commented that a very serious effort was being made in the Congress to legislate an expenditure ceiling.

Representative Wilbur Mills, Chairman of the House Ways and Means Committee, was working hard for expenditure restraint; he had a great deal of support, and prospects for passage by the House were excellent. In the Senate, prospects for passage were uncertain. Senator Roth had obtained a large number of sponsors for his bill to establish a ceiling, but the position of Senator Long, Chairman of the Finance Committee, was not known.

Chairman Burns added that even if an expenditure ceiling were legislated, it would not last indefinitely. The merits of a ceiling were being increasingly recognized, but it also had a profound weakness in that the Congress virtually abdicated its role in establishing priorities. The Congress would not be willing to do that for long. If enacted, however, a ceiling would provide an opportunity to work out other mechanisms for imposing financial restraint.

Mr. Brimmer observed that the latest staff projections suggested greater strength in activity than had the projections of either August or June. The latest projections also suggested a somewhat greater acceleration in prices beginning in mid-1973 and more of a decrease in unemployment than had been indicated earlier. The assumed rates of growth in money and credit

in the third and fourth quarters of this year now were higher than those the Committee had taken as targets, and he expected that growth would be at about the assumed rates. Therefore, the Committee was confronted with the issue of when, rather than whether, it would proceed to moderate the rate of monetary growth. The staff had argued that the higher rates of monetary growth in the third and fourth quarters of this year would make little or no difference to economic developments, suggesting that the Committee might have a few months of leeway as to when it took action. He asked Mr. Gramley to comment.

Mr. Gramley said econometric models suggested that it would make little difference to developments 2 years or so ahead whether monetary expansion proceeded at a rate of 8 per cent in the second half of this year and 4 per cent in the first half of 1973 or alternatively at a rate of 6 per cent throughout the period. However, he thought it would be safer to pursue a steadier path, particularly when it appeared that demand pressures would intensify as the year progressed. There was not sufficient experience in the postwar era to permit more than very general statements about the effects of uneven versus steady monetary growth.

In reply to a question by Mr. Daane, Mr. Gramley added that in the case where monetary growth was at a rate first of 8 per cent and then 4--as compared with 6 throughout the period--interest rates

would tend to be held down in the first part of the period but then to be increased sharply, creating potentially disturbing effects in financial markets.

Chairman Burns observed that, at present, the rate of unemployment was about 5.5 per cent and the rate of capacity utilization was well below its potential. Since April industrial production had grown at an annual rate of only 4 per cent, and over the past 6 months the physical volume of construction had been declining gently. Services were the only sector of the economy that had been expanding vigorously. Consequently, employment had been increasing at only a moderate pace. Clearly, the economy was not booming.

Continuing, the Chairman noted that wholesale prices had shown some disconcertingly large increases recently. However, the price situation was mixed. Prices of sensitive industrial materials had stabilized in recent weeks, following a sharp rise. Food prices also had stabilized recently, according to statistics that had not yet been released.

Concerning the outlook, Chairman Burns said no scientific means of projecting prices had been developed, and everyone had to form his own judgments. In his view, the critical factor in price developments next year would be the behavior of wages. The nature of the wage guideline decided upon by the Pay Board within the next few months--and whether any reduction could be made to stick--would be decisive. If the Pay Board reduced

the guideline from the prevailing 5-1/2 per cent down to 4-1/2 per cent--or preferably to 4 per cent--he would be very optimistic about price prospects for next year. If the Board did not take such action, inflationary pressures might well be renewed.

Chairman Burns observed that the Pay Board was likely to announce its decision early next year, well in advance of the scheduled expiration of the Economic Stabilization Act. The environment existing then might determine the decision, and that environment depended on the behavior of prices, profits, dividends, and interest rates. If the Price Commission became tougher than it had been of late, if the rise in profits moderated, if dividends continued on their recent course, and if interest rates did not rise appreciably, the environment would be favorable to a decision to reduce the wage guideline. If the environment were not so favorable and the Board nevertheless lowered the guideline, its decision might not be allowed to prevail. That would depend on attitudes in the country--particularly in the labor unions and in the Congress. If prices, profits, and interest rates were rising materially at the time the Economic Stabilization Act came up for renewal next year, the Congress would be unlikely to accept a wage guideline of 4 or 4-1/2 per cent.

Altogether, the Chairman concluded, he was moderately optimistic about price prospects for the next year. He was reassured by a certain determination within the Administration to

continue the controls program. Some members of the Pay Board were eager to lower the wage guideline, provided that the environment proved to be favorable. Prospects for fiscal restraint were good. And he felt the Federal Reserve would assure that the average rate of monetary growth was moderate over periods of 6 months or a year, even if it permitted rapid growth for briefer intervals. He noted that despite concern at times that monetary growth was too rapid, the narrowly defined money stock had risen over the year ending in August by only 5-1/2 per cent.

Mr. Eastburn remarked that it was helpful to have Chairman Burns' assessment of the various ingredients in an effective program of controls. He noted that if fairly rapid growth in the monetary aggregates for a period of time were followed by much slower growth in order to average out to a reasonable rate, interest rates might rise substantially. He inquired whether, in the Chairman's view, substantial increases in interest rates then would undermine the program of controls.

Chairman Burns replied that the question was very hard to answer. It was clear that the Pay Board would find it extremely difficult to lower the wage guideline if consumer prices, profits, and interest rates were rising rapidly and if the Committee on Interest and Dividends responded to pressures to relax the dividend guidelines. One thing of which he was certain was that the dividend

guidelines would not be relaxed. Assuming, however, that over-all developments were of a kind that permitted the Pay Board to lower the wage guideline, subsequent sharp increases in interest rates might well create problems.

The intensity of those problems would depend on how the the whole situation unfolded, the Chairman continued. In general, the rate of increase in consumer prices would be much more important than changes in interest rates; and changes in the interest rates of most significance to consumers--particularly rates on mortgages and on consumer instalment loans, which tended to be sticky--would be more important than, say, the prime rate or other lending rates to business. He doubted that sharp increases in interest rates of the latter types would have much of a psychological impact if at the same time the consumer price index were rising no faster than, say, 2 tenths of a percentage point per month.

Mr. Hayes commented that some weight should be given to the psychological effects of a high rate of monetary growth over an extended period. In the past when the public in general and businessmen in particular viewed monetary policy as loose, attitudes and decisions concerning prices had been affected.

Mr. Brimmer remarked that he was concerned about the appropriate role of monetary policy as an instrument of economic

stabilization over the next 9 to 12 months. Committee members were aware that monetary policy functioned with a lag, and they were confronted with the need to assess the possible effects of policy over a period of time. In that context, he believed that possible future actions of the Pay Board and the course of fiscal policy should influence the Committee's decisions, but they should not be decisive; monetary policy had an independent role to play.

Continuing, Mr. Brimmer observed that economic activity was gaining strength. Output and employment in the third or fourth quarter of 1973 would not benefit very much if the monetary aggregates were allowed to continue to grow at recent rates; the impact would be greater on the rate of increase in prices. Experience in the 1965-66 period indicated that timeliness was as important as direction in monetary policy actions.

Mr. Daane commented that there was a tendency to exaggerate the independent role of monetary policy. The Committee had to do the best it could with monetary policy while recognizing its limitations. The economy was subject to the influence of so many other variables--such as interest rates, fiscal policy, and expectations--that one could not clearly say that a difference of a certain amount in the rate of monetary growth would have a specific effect on the economy.

Mr. MacLaury said that he, like Mr. Eastburn, had found Chairman Burns' assessment of the situation helpful. He asked the Chairman, in view of his references to certain signs of slackening in the second quarter and apparently into July and August as well, whether he concurred in the staff's forecast for the real economy and the relatively bullish expectations for retail sales and inventories.

Chairman Burns replied that he did.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period August 15 through September 13, 1972, and a supplemental report covering the period September 14 through 18, 1972. Copies of these reports have been placed in the files of the Committee.

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

> Over the period since the Committee last met the monetary and credit aggregates exhibited vigorous growth, and as the Desk attempted to keep on the RPD target, short-term interest rates rose sharply. In the process, financial markets became increasingly sensitive, particularly just before the Labor Day weekend when the banking system badly misjudged its reserve needs and forced the Federal funds rate up as high as 5-1/2 per cent. In order to avoid a completely unwarranted run-up of interest rates and the risk of disorderly market conditions, the Desk was obliged for a time to adopt a less vigorous pursuit of the Committee's reserve objectives. Currently--with a measure of calm returned to the money markets--we

have been aiming at a reserve approach that would envisage a 5 per cent Federal funds rate. The continuing sensitivity of the markets made it appear undesirable to aim at reserve conditions that would go to the upper end of the 4-1/2 to 5-1/4 per cent Federal funds range specified by the Committee at the last meeting.

Treasury bill rates, which had been abnormally low relative to other short rates, showed the most adjustment. With dealer inventories high, the market reacted sharply to selling by the Treasury, System, and foreign accounts. The System, too, was running off Treasury bills in the regular weekly auctions in order to cut back reserves in the banking system, and this, together with reduced foreign participation, required the market to absorb more bills than it wanted. Earlier, bids entered by the Desk for System and foreign accounts had amounted to as much as two-thirds of the total amount awarded in the regular 3-month bill auctions. In the past few weeks such bids fell to only about one-half of the total. In yesterday's auction, average rates of 4.63 and 5.10 per cent were established for 3- and 6-month bills, each up about 65 basis points from the auction just preceding the last meeting of the Committee.

Other short-term rates also rose, but more moderately, bringing about a more normal relationship between rates on Treasury bills and on other short-term instruments. In longer-term markets, Treasury issues again showed the most adjustment as dealers tried to work off--at substantial losses--the inventories acquired in the Treasury's August refunding. In the corporate and municipal markets--where the calendar remained relatively light--rate adjustments were more moderate, ranging from 10 to 15 basis points.

As mentioned earlier, a somewhat calmer atmosphere has emerged in the markets in the past week. Government dealers have--with the exception of an overhang of the 6-3/8s of 1984--about completed their inventory adjustment of Treasury coupon issues. Treasury bill holdings are still high, however, and the market is still sensitive to any new economic developments or to a further firming of System policy.

The Treasury, as you know, has been experiencing a cash problem. Their balance with the Fed has been worked down--supplying reserves in the process--and

they had a small overdraft with the System a week ago. With September tax money coming in, their position has improved to the extent where they can shortly run the balance up again to $2 billion or so--and help absorb much of the reserves that will be supplied, should the prospective changes in Regulations D and J be implemented as scheduled. The Treasury still has to raise about $10 billion in cash over the remainder of the year, with the first bite scheduled for next month. While no decisions have been made, the financing is apt to take the form of an issue of tax-anticipation bills, which should involve minimal even keel considerations for the System.

Open market operations over the period were plagued by the need to absorb a large volume of reserves at a time when the Treasury and foreign accounts were large sellers of Treasury bills in a market that had become increasingly sensitive as a result of the strong economic outlook and the System's attempt to put the brakes on reserve growth. While the reserve pattern indicated a need to make outright market sales of Treasury bills over much of the period, the sensitivity of the market was such as to require heavy use of matched sale-purchase agreements instead. The System did sell nearly $500 million bills in the market and more than that amount to foreign accounts. Another $1 billion of bills were redeemed in the auctions. Matched sale-purchase agreements, however, amounted to nearly $8 billion, and were used especially heavily in the past statement week.

The aggregates and RPD's are turning in a very strong performance, as the blue book[1/] and other written reports to the Committee have indicated. A sizable part of the overshoot on RPD's--2 percentage points--can be accounted for by the bizarre performance of the banking system before the Labor Day weekend. As you know, banks acted as if reserves were scarce, bidding up the Federal funds rate to well over 5 per cent and borrowing $1 billion over the long weekend,

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

despite a large injection of reserves through repurchase agreements by the System to try to dampen the feeling of extreme tightness that had developed. By Tuesday the banking system had, in fact, accumulated over $8 billion in excess reserves, and it wound up the week with a daily average of $838 million in excess reserves--four to five times the normal amount. With that high a level of excess reserves, there was no way to keep on the RPD path. A missed target produced by an aberration of excess reserves should not be a cause for great concern. But even apart from this, RPD's have been running at or above the upper end of the target range and only the sensitivity of the market prevented still more vigorous action by the Desk to absorb reserves.

Looking ahead, the blue book is forecasting excessively strong rates of growth of money in September and in the fourth quarter. I should note, but without any feeling of confidence, that the New York projections are forecasting a 6-1/2 per cent rate of M_1 growth in September and only 5-1/2 per cent for the fourth quarter with virtually unchanged money market conditions. I suspect that they are probably wrong, but it may serve as a reminder that forecasting is not exactly a science, and that the linkages between money market conditions and growth of the aggregates can be highly uncertain. The projections are being put to the test in this current week, on which we will have better information by this Thursday. Our projectors--who I believe are putting heavy weight on the shift in the Treasury balance--are forecasting a level of M_1 about $1.8 billion below the Board staff's estimate.

As the blue book indicates, the Committee faces a difficult trade-off between interest rates and the aggregates in the period ahead. The problem would not be so difficult if--by any chance--the New York estimates turn out to be more nearly right, since they imply less pressure on interest rates to achieve a reserve or aggregate target. With markets still sensitive, it would be helpful if members of the Committee would indicate how relentless they would like the Desk to be in pursuing whatever target the Committee may choose today. We will probably need a fair amount of flexibility in open market operations in light of the scheduled changes in Regulations D and J, whenever they may occur, and continued bill selling by foreign central banks--if it occurs--could add to problems. As you know, on occasion in the past period the System took bills from

> foreigners in order to avoid pressing the bills on an unreceptive market, and it tried to offset the unwanted reserve impact by other means. On occasion, too, the Desk bought short-term bills offered by some foreign accounts and sold longer-term bills demanded by other foreign accounts, thus avoiding any reserve impact. We may have to continue to operate in this manner from time to time.
>
> Should the markets become excessively restive once again, it might also prove desirable for the System to buy, for example, long-term bills or other specific issues which are a drag on the market, and offset the reserve impact by selling short-term bills or by making matched sale-purchase agreements. Normally the System avoids making such market swaps and I believe that is a proper procedure. But on occasion such operations might help keep markets orderly while the Desk seeks to pursue reserve growth objectives, and I would recommend that the Committee be willing to tolerate them if they appear to be necessary in the weeks ahead.

Mr. Coldwell asked whether any opportunities had been found in the recent period to offset the unwanted reserve impact of bill purchases from foreign accounts by sales of coupon issues or longer-term agency issues in the market.

Mr. Holmes replied that no such sales had been made since they probably would have resulted in spreading the short-term market pressures into longer-term markets--particularly since dealers had been trying to work off high inventories of coupon issues. More generally, if the System decided to engage in sales of longer-term issues it would be desirable not to take the market by surprise, in order to avoid an overreaction.

Chairman Burns added that in his judgment System sales of coupon and longer-term agency issues in the recent period would

inevitably have been interpreted by the market as indicating a determined Federal Reserve effort to raise the entire interest rate structure. The market had already formed an exaggerated impression of the System's intentions from the operations actually conducted, and sales of longer-term issues would have carried that process further.

Mr. Daane noted that, according to the blue book, an increase in the Federal funds rate of the magnitudes shown under the specifications for alternatives B and C[1/] would lead to an upward adjustment in the bill rate in a 4-3/4 to 5-1/2 per cent range. He personally found it hard to believe that the bill rate could be kept within that range if the funds rate were to rise to the 5-3/8 per cent level associated with alternative C. He asked for the Manager's judgment as to how vulnerable the market was at present to increases in the Federal funds rate.

Mr. Holmes replied that the market was in a much better technical position now than it had been a short time ago, and accordingly it should be better able to withstand some further firming in money market conditions without reacting unduly. However, he found it very difficult to pinpoint the particular level of the funds rate that would precipitate an undesirable reaction.

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

One major uncertainty was whether foreign central banks would continue to be large sellers of bills.

Mr. Mitchell recalled that at the previous meeting Mr. Sternlight had expressed the view that the market could accept a Federal funds rate of about 5 per cent without much trauma, but that to push beyond that level would pose greater risks for the stability of longer-term interest rates. In his (Mr. Mitchell's) view, ever since the publication of figures showing a large increase in M_1 in July, market participants had been awaiting a signal that the System had launched on a firming course, and he thought the sharpness of the reaction in the days before the Labor Day weekend was attributable in part to their belief that the System had given the anticipated signal. Now that August figures showing more moderate growth in M_1 had been published the market might well be less sensitive. He asked what reaction the Manager would expect to Federal funds rates consistently above 5 per cent.

In reply, Mr. Holmes said he thought the market probably would not be greatly disturbed at present by funds rates a little above 5 per cent and perhaps even higher. There would, of course, be some reaction in other market rates as the funds rate moved up, but not necessarily a disproportionate reaction. He added that he would be inclined to attribute the turmoil in the market just

before Labor Day primarily to the banks' misjudgments of their reserve positions. He did not fully understand the reasons for that behavior, but it was consistent with a recent trend toward increasing problems of reserve management in connection with long holiday weekends.

Mr. Daane asked what constraint the Manager would suggest for the funds rate if the Committee desired to keep the market uncertain as to whether it had decided to move in a firming direction.

Mr. Holmes replied that he was unable to specify any particular range that would produce such a result. In his judgment the range could be determined only by moving toward a higher rate, while standing ready to back away if necessary and, perhaps, trying again later. Such an approach would be feasible unless the Committee was determined to achieve some particular growth rates in the aggregates.

Mr. Daane remarked that that approach could be described in old-fashioned terms as a "probing operation," and Mr. Holmes agreed.

Mr. Eastburn noted that, under the experiment the Committee had been engaged in since February, point 5 of the points for guidance of the Manager read as follows: "If it appears that the Committee's various objectives and constraints are not going to

be met satisfactorily in any period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions." He asked whether consideration had been given to the possibility of consulting with the Committee in the period since the last meeting.

Chairman Burns responded affirmatively. He noted that he had talked with the Manager several times during the period, and that in his own thinking the question of whether to consult with the Committee had hung in the balance for a number of days.

Mr. Holmes added that there were arguments in favor of not holding a special meeting at a time when markets were highly sensitive and bordering on disorder; by waiting until the situation had calmed down somewhat the Committee would be in a better position to reassess the situation.

Mr. MacLaury said he was somewhat disturbed by the implication of Mr. Daane's line of questioning that there was some level of the Federal funds rate, determined by market psychology, that should not be pierced. Obviously, no one wanted markets to become disorderly, and it would be a great advantage for the Committee to know in advance what circumstances would create exaggerated interest rate movements. He would be concerned, however, if the Committee's policy decisions were dictated by psychological considerations rather than reflecting more fundamental factors.

Mr. Mitchell commented that for many years the Committee had in fact given the Manager guidelines in terms of market psychology, in what could be described as a "seat-of-the-pants" operation.

Mr. Daane said he had not meant to suggest that the Committee should specify some rigid upper limit for the funds rate in the coming period. As the Manager had indicated, it was not possible to name in advance the precise level of the funds rate that would trigger a sharp market reaction, and he (Mr. Daane) would want to give the Manager latitude for the exercise of judgment.

Mr. Sheehan expressed the view that a key issue underlying the questions raised by Messrs. Daane and Mitchell was whether interest rates had risen in the recent period mainly because of market forces, or whether they had been inadvertently pushed up to undesired levels by the System's operations.

Chairman Burns noted in that connection that the bill rate had risen about 80 basis points in the recent interval. At the previous meeting there had been fairly wide differences in the members' opinions on policy, but according to his recollection no one had said or implied that he favored an increase in the bill rate of that magnitude. He assumed that that was one of the considerations Mr. Daane had had in mind in his questions today.

In his judgment, the Chairman continued, market participants were concerned not so much with particular levels of money market rates as with the apparent trend in System operations over time. If, for example; it appeared that the Desk was seeking to move the funds rate steadily in a particular direction during, say, a two-week period, the market was likely to extrapolate that trend into the more distant future and react in an exaggerated way. Alternatively, if the Desk moved toward its goal along a zig-zag course, it would create uncertainty about its objectives which might minimize chances of exaggerated reactions. He asked whether the Manager agreed.

Mr. Holmes remarked that the consequences of particular approaches varied with circumstances. There were times when the Desk could put relatively steady pressure on the market without producing sharp reactions. At other times, however, the situation was just as the Chairman had described it.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 15 through September 18, 1972, were approved, ratified, and confirmed.

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

After reading the blue book material, you may feel that the staff is engaging in the exercise of excessive fine-tuning. It is true that financial relationships are unlikely to develop exactly as projected or planned. And the margins of error within which the vagaries of human behavior and the state of the economic art permit us to work could well mean that the alternatives presented may in practice fade into one another rather than turn out to be distinct, mutually exclusive paths.

But the alternatives are designed to bring out a number of points deserving of Committee consideration. The alternatives recognize, for one thing, that the recent rise in short-term rates has already set in motion forces that will result in some slowing in aggregate growth rates from the third-quarter pace, even if money market conditions firm no further. However, the extent of such a slowing--shown in alternative A--would still leave the aggregates growing at rates considered excessive by the Committee in the past. If a further slowing is to be achieved, the alternatives suggest that the necessary constraint on reserve growth will lead to a further tightening of the money market.

There are many ways in which reserve and aggregate growth slower than alternative A can be achieved. While in our analysis they all involve tighter money market conditions than prevailing, the degree of tightness may develop either quickly, gradually, or after some delay. The longer the needed tightness is delayed, the less is the retardation likely to be achieved in aggregate growth, or the higher are the interest rates eventually required to attain a given aggregate growth by a particular time.

The larger than usual number of alternatives presented in the blue book illustrate trade-offs between money market conditions and the speed with which growth in the aggregates is slowed insofar as we can estimate them. The gradual approaches of alternatives B and C do not achieve quite as much retardation in growth of monetary aggregates by the first quarter of next year as does the more marked tightening of alternative D. The more gradual approaches have the advantage, though, of being much less likely to involve sharp, adverse, short-run repercussions on credit market psychology.

And monetary growth can then be restrained further later on--achieving M_1 growth rates in the neighborhood of 5 to 5-1/2 per cent in the second quarter--with only a modest further tightening of the money market likely to develop by early next year.

While the relation among reserve paths, monetary aggregates, and interest rates is always subject to a margin of error, in the period immediately ahead the relationship is particularly difficult to foresee. On the assumption that the changes in Regulations D and J take effect this Thursday, there will be considerable uncertainties affecting the demand for excess reserves and the multiplier between reserves and deposits for reasons explained in the blue book. These uncertainties affect what we generally term the supply function for money. The more uncertain we are about the supply function, the more difficult it is, of course, to control money or bank credit by controlling the reserve base.

In the period of transition--while banks (and the System also) are adapting to the new Regulations D and J--it might, therefore, be desirable to give somewhat more weight to money market conditions relative to bank reserves in attaining aggregate objectives. The RPD path will still be a useful guide, but technical changes in the path relative to aggregate objectives are somewhat more likely to occur in the transition period.

The still fairly sensitive state of credit markets is another reason to put some additional weight on money market conditions in the period immediately ahead. While the technical condition of credit markets has improved in the past few weeks, investors and dealers are still highly sensitive to changes in monetary policy indicators. One major question in the market concerns how accommodative the Federal Reserve is likely to be in this coming period of seasonal upward pressures on short-term rates. Clear indications that the Fed is willing to permit or encourage tightening could lead to further anticipatory upward adjustment of bill and other short-term rates and to questions about the sustainability of the discount rate.

Nevertheless, it would seem to me that the Committee might wish to start now on an effort to slow growth in the aggregates to rates below those shown for alternative A. Given existing market conditions, though, the Committee may wish to be cautious in the degree of tightening permitted

> money markets as part of that effort. Our analysis of the trade-offs between aggregate growth and interest rates suggests that the cost--in terms of control of the aggregates over an economically meaningful period--of moving quite cautiously at this point is not very large, assuming some willingness to exert continuing restraint as time goes on.

Mr. Brimmer referred to his earlier question to Mr. Gramley regarding the amount of latitude available to the Committee in moving to moderate growth in the monetary aggregates. He asked for Mr. Axilrod's view of the probable consequences if that move were delayed for 2 or 3 months.

In reply, Mr. Axilrod observed that the staff's GNP projections were based on the assumption that growth in M_1 would be brought back down to the Committee's earlier target rate of 6 per cent by the first half of 1973. Given the likely strength of money demands, the postponement of any firming of money market conditions for, say, 2 months would probably result in the need for a relatively sharp tightening in the final 6 weeks of 1972 if a 6 per cent M_1 growth rate were in fact to be achieved in the first half of 1973. There were, of course, alternative ways of approximating that goal; one which the staff had explored involved an M_1 growth rate of 6-1/2 per cent in the first quarter and 5 per cent in the second quarter. In that alternative, the degree of restraint placed on the growth of reserves in the final weeks of 1972 probably would be sufficient

to push both the Federal funds rate and the bill rate up to the area of 6-1/2 per cent by early January.

Mr. Mitchell noted that, according to weekly data shown in the blue book, most of the growth in private demand deposits since mid-May had occurred in two brief periods that included holidays--the first two weeks of July and the two weeks ending September 6. He asked if Mr. Axilrod had any ready explanation for that phenomenon.

Mr. Axilrod replied that he found it extremely difficult to explain changes in the weekly money supply series, largely because of the serious problems of making seasonal adjustments in such data. Those problems were magnified in weeks with holidays that could occur on different days of the week, such as Independence Day. In general, one had to consider periods longer than one week to detect significant trends in the data. He had been surprised by the sudden sharp increase in M_1 in the first 2 weeks of July, but he had been even more surprised by the failure of the series to decline more than it had in subsequent weeks. The fact that the money supply had remained near the early-July peak suggested that fundamental forces were making for strength in money demands. For all practical purposes, however, the particular weeks in which the strength was reflected in the data were, to a large extent, either random or a function

of the inadequacies of the seasonal adjustment process for weekly data in a series subject to sizable, unpredictable changes.

In response to a further question, Mr. Axilrod said the Board staff's projections suggested that the money stock would remain roughly stable in the final 2 weeks of September. In contrast, the New York Bank anticipated a decline.

Chairman Burns recalled that the staff had recently made a study of the errors in projections of the monetary aggregates. He asked what the study had revealed about the relative accuracy of the projections made at the Board and the New York Bank.

Mr. Axilrod replied that the New York Bank's projections had proved better than the Board's for the bank credit proxy, and slightly better for M_2. For M_1 the Board's projections were better on a monthly basis but there was little difference in the relative accuracy of the quarterly projections.

Mr. Axilrod added that in preparing such projections the staffs took into account the findings of a rather large number of models. Two models--plus the exercise of independent judgment--were used regularly at the Board, and other predictive equations prepared at the New York Bank were also consulted. The various models and equations that he had recently seen showed projections of the growth rate of M_1 in the first quarter of 1973 ranging

from 4 to 11 per cent, all based on the assumption of no change in money market conditions.

Chairman Burns then remarked that the Committee appeared to be ready for its discussion of monetary policy and the directive for the coming period. He invited Mr. Brimmer to open the discussion.

Mr. Brimmer observed that, as earlier questions of his indicated, he was concerned about the appropriate timing of a move to slow expansion in the monetary aggregates. He thought it was desirable to act now, when the move could be a moderate one, rather than delay until a time when drastic action would be needed. He hoped the Committee's debate would focus on the question of how much of an increase in money market rates would be acceptable.

Personally, Mr. Brimmer said, he favored the specifications of alternative C, although he would be willing to accept those of alternative B. The Desk needed more than the usual amount of latitude in this period in view of the scheduled implementation of the changes in Regulations D and J, but he hoped it would still be able to achieve some moderation in the growth rates of the aggregates. Over the last 4 weeks it had been decided to permit some slippage from the Committee's objectives because of the sensitive state of the money markets; and while he had accepted that judgment when it was made, he thought the Desk should now give a little less weight to sensitivity in the markets and more to the objective

of slowing the aggregates. In response to the Manager's specific question as to how relentlessly the Committee's targets for the aggregates should be pursued, he would say that operations should not be extremely vigorous, but that they should nevertheless be designed to avoid further slippage.

Mr. Hayes remarked that a month ago Committee members had agreed that it was important to achieve some slowing in the growth of the monetary and credit aggregates. Unfortunately, that slowing had not occurred, at least not in anything like the degree that had been hoped for. He intended no criticism of the Desk; concern for market sensitivity had prevented it from using the full permissible range of the Federal funds rate constraint even though RPD's and the aggregates were all well above path. But the recent and prospective aggregate growth rates looked decidedly excessive in the light of the strengthening business situation, the disturbing budgetary outlook, and the widespread fear of a new surge of inflation in 1973.

Of course, Mr. Hayes continued, it might be argued that the Committee was not really willing to use an RPD target when the price was any substantial rise in interest rates. Yet it seemed quite clear that that trade-off could not be ignored or escaped. A further increase in short-term market interest rates was probably the price the Committee would have to pay if it was

going to keep any semblance of control over the aggregates in the coming months, and it might be easier to firm now than later in the year when the Treasury would face heavy financing needs. Also, like Mr. Brimmer, he would prefer to start soon and move gradually rather than delay until drastic action was needed.

Chairman Burns remarked that an economic historian examining the record for the year would probably conclude that the Committee had started to move some time ago.

Mr. Hayes agreed, adding that he was thinking of a start toward achieving further moderation in the aggregates. Certainly, the growth rates sought for the fourth quarter should be substantially lower than those that had prevailed recently. Ideally, a range from 5 to 6 per cent in the annual rate of growth in M_1, with commensurate ranges for M_2 and the credit proxy, might be appropriate. However, if the blue book relationships were anywhere near the mark--and he thought they well might be--the interest rate firming required to achieve such growth rates would be too high a cost to pay, at least in the near future. Also, he was impressed by the fact that the changes in Regulations D and J--if they became effective--would make it unusually difficult to achieve any goal measured in terms of reserves. Under those circumstances, he thought the most practical approach would be to set the Committee's target for the next period in terms of moderately firmer money

market conditions. The specifications for money market conditions associated with alternative C, with a range of 5 to 5-3/4 per cent for the funds rate, looked about right to him. He would hope that such money market conditions would result in slower growth of the aggregates in coming months than forecast in the blue book, but if they did not the Committee would simply have to accept the outcome.

As for the discount rate, Mr. Hayes said he thought the time had come for action by the System. So far he had been inclined to temporize on that issue, but meanwhile market rates had been moving upward. Furthermore, he could see the need for a visible, though moderate, signal that the System was concerned over the course of the aggregates and the budgetary and inflationary outlook. When the New York Bank directors had reestablished the present rate 2 weeks ago they had done so only with reluctance, and they had expressed to the Board of Governors their serious concern regarding the prospects for intensified inflationary pressures, particularly in the light of the Federal budgetary outlook. He would not expect them to stand still again this week, and his present inclination was to recommend an increase before even keel considerations arose.

Mr. Hayes observed that the principal question remaining in his mind concerned the most suitable amount of such an increase. Ordinarily, in view of the inflationary risks, he would lean

toward a half-point rise, even though that might have some further effect on short-term market rates. On the other hand, he was quite aware that the System was in a delicate position in a period of wage and price controls, so that discretion in the form of a quarter-point move might recommend itself. He would, of course, be interested to hear how others around the table felt on that issue.

Mr. Eastburn said he would make only three points, all of which seemed to him to argue for taking action now to moderate the rates of growth of the monetary aggregates. First, the blue book projections of the aggregates might again prove to be under-estimates of the actual growth rates, as they had in the recent past. Second, even keel considerations would soon become important. Third, as Mr. Axilrod's response to Mr. Brimmer's question made clear, it would be difficult to compensate later for overly rapid growth in the aggregates now. He favored alternative C.

Mr. Winn noted that he had participated in the daily conference call during the past month and that, as a relative newcomer to the Committee, he had been impressed by the extraordinary variety of forces with which the Desk had to contend. On studying the blue book, he had concluded that the Committee would be fortunate if it could produce results anywhere within the full range of the alternatives presented, let alone hit the targets specified under some one of the alternatives.

Mr. Winn then observed that he was disturbed about the developing inflationary psychology. Unfortunately, the recent high growth rates in the monetary aggregates were contributing to that psychology, particularly since the public appeared to be accepting the view that monetary growth rates were the key indicator of policy. He would be concerned about the effects of publishing figures for September showing another month of rapid growth, and accordingly he would like to see the Committee move a bit further toward slowing the aggregates than it had done thus far. He favored the specifications of alternative C.

In a concluding observation Mr. Winn said that while regulation of stock market credit did not fall within the Committee's range of responsibilities, he would note that he remained concerned about developments in that area.

Mr. Coldwell remarked that in open market operations since the last meeting problems of market instability had taken precedence over the attainment of the aggregate targets the Committee had adopted. He thought the Committee could not accept a continuation of excessive rates of growth in the aggregates, like those recorded recently and projected for the future, unless it also was prepared to accept responsibility for the inflationary consequences of such growth rates. The alternative course was to move toward lower growth rates as promptly as

possible, even if that meant some modest increase in market interest rates--perhaps including an advance in the discount rate. He did not favor higher interest rates as an end in themselves, and he recognized that they might be unpopular in a period of wage and price controls, but he was willing to accept higher interest rates if needed to curtail the present rate of growth in reserves and in the credit base. He thought the Committee could not afford to wait or temporize any longer, given the expansion in money that was already in place.

Mr. Coldwell said he was dissatisfied with all of the staff's alternatives for the operational paragraph of the directive. He would prefer a paragraph reading as follows: "To implement this policy, while taking account of developments in credit markets, international developments, and the effects of bank regulatory changes, the Committee seeks to achieve an orderly tightening in bank reserve and money market conditions which will foster slower growth in monetary aggregates over the months ahead." That, in his judgment, was a direct statement of the appropriate objective. In implementing such a directive, he would favor a progressive increase in the Federal funds rate, although he hoped the funds rate would not have to rise above 5-1/2 per cent. Also, he thought that use should be made of every possible opportunity to reduce reserve availability,

and--if market circumstances permitted--that securities sold by the Desk should include longer-term issues.

In a concluding observation, Mr. Coldwell said he probably would soon recommend a quarter-point increase in the discount rate to the directors of the Dallas Reserve Bank.

Mr. Mayo remarked that, like a number of others, he favored alternative C. For the Federal funds rate, he believed a range of tolerance of 4-3/4 to 5-3/4 per cent around the 5-3/8 per cent figure shown under C would be appropriate, although he hoped the funds rate would not have to rise anywhere near 5-3/4 per cent.

Mr. Mayo went on to say that he thought the Manager should be given more than the usual amount of latitude during the period in which the financial system was digesting the effects of the changes in Regulations D and J, since it was impossible to foretell the specific form those effects would take. Moreover, he would want to instruct the Desk to place much more than the usual amount of emphasis on money market conditions in the coming period. He was not suggesting that the Committee abandon its current experiment, and he thought it would be appropriate for it to continue to specify goals in terms of RPD's. However, in view of the uncertainties created by the System's own action in adopting the D and J changes, it would be desirable to engage temporarily in what might be described as an "even keel" operation.

For similar reasons, Mr. Mayo continued, he would prefer to delay an increase in the discount rate for a few weeks, even though he believed an increase this week or next probably could be justified on strictly economic grounds. The delay would give the System an opportunity to observe the effects of the regulatory actions. Also, now that the System had indicated its willingness to make the discount window available to both member and nonmember banks to facilitate their adjustments to the actions, it would seem desirable to keep the rate unchanged for a few weeks.

Mr. Morris remarked that before turning to current policy he might first call the Committee's attention to a development on which he had been pondering recently. Despite the fact that the Federal Reserve had been following an expansionary policy for 2 years or more, most measures of liquidity indicated that the position of New England banks, at least, was quite illiquid. He believed that in recent years banks had greatly intensified their efforts at aggressive portfolio management. That was reflected, for example, in the fact that New England country banks as a group had been net buyers of Federal funds for the past several months; at the moment, their net purchase position was as high as at any time in 1969. He was not sure whether greater aggressiveness was a New England phenomenon or a national one, and he thought it would be desirable for the staff to undertake

research on that question. If the phenomenon was national, it would suggest that the banking system was likely to respond more quickly to a firming of monetary policy than it had during the recoveries from past recessions, when banks had started from more liquid positions. It might also help explain the sharpness of the recent rise in short-term interest rates.

As to current policy, Mr. Morris said he would support alternative C. Even if growth in the aggregates slowed to the extent projected under that alternative, for 1972 as a whole M_1 and M_2 would rise at rates of 8.1 and 9.8 per cent, respectively. Since he thought the Committee would not want growth for the year to exceed such rates, it would seem desirable to continue to move toward higher money market rates. The 5-3/8 per cent central value shown for the funds rate under alternative C appeared to him to be appropriate. If the Committee adopted alternative C he would expect the Desk to operate a little more aggressively in the next 4 weeks than it had in the recent period.

Turning to the discount rate, Mr. Morris said it was his view, and also that of the directors of the Boston Bank, that once the discount rate got substantially out of line with market rates it was very difficult to bring it back into line. It seemed to him that the System had to decide now whether it

intended to keep the discount rate in fairly close alignment with the market in the future. If the answer was yes, then an increase in the rate would seem appropriate now. All of the evidence suggested that the uptrend in money market rates was not just a temporary development, and if the discount rate were held at its present 4-1/2 per cent level much longer it was likely soon to be a full percentage point below the Federal funds rate. The System would then be faced with a much greater problem than if it had kept the margin narrow by taking successive small bites.

Mr. Francis said he would associate himself with those who had expressed a desire to move towards slowing the rate of expansion in the monetary aggregates as soon as possible. In that connection, he noted that the staff's GNP projections--which, on the whole, appeared reasonable to him--suggested that the rate of increase in average prices would rise progressively throughout the four quarters of 1973. An assumption underlying those projections, according to the green book, was that M_1 would expand at annual rates of 9 and 7 per cent, respectively, in the third and fourth quarters of 1972, and at a 6 per cent rate in 1973. Such growth rates were almost exactly the rates called for under alternative D, the most restrictive of the 4 policy alternatives described in the blue book; the only exception was that the growth

rate for the third quarter of 1972 shown under D--as well as under the other alternatives--was at the somewhat higher level of 10-1/2 per cent. Such a comparison suggested that the Committee might want to consider alternatives even more restrictive than D. On balance, however, he thought growth rates in the vicinity of those shown under D would not be far wrong.

Mr. Heflin said he was as concerned as anyone at the table about the problem of inflation, but he was also aware of other considerations that the Committee had to take into account in deciding on policy. As the Chairman had indicated, the economy was not yet in a boom situation. In particular, the fact that there was still some distance to go before full employment, on any reasonable definition, was reached constrained the Committee's freedom of action. He did not think Committee members would want to ignore their objectives in the area of employment--which, indeed, were objectives of over-all Government policy--or would want to take any monetary action that could result in pinching off the recovery before the employment objectives had been attained. It would be better, he thought, to let the nation's pool of unused resources take care of the demand aspects of the inflation problem, and to let the wage-price program take care of the cost-push aspects. And he did not think the members could ignore the implications of interest rate movements for the problems facing the Committee on

Interest and Dividends and for the Government's control program as a whole.

That was not to say, Mr. Heflin continued, that he would not want to move toward a more restrictive monetary policy at this time. The question was how far to move. It seemed to him that an increase in the Federal funds rate over the next 4 weeks to, say, 5-3/4 per cent would give the market a signal that should not be given at this time. It was not at all clear to him that that much of an increase was necessary to avoid the kind of drastic action later which Mr. Axilrod had described in response to Mr. Brimmer's question about the consequences of delaying action altogether.

On balance, Mr. Heflin observed, he favored specifications closer to those of alternative B than C. He would set a 5-1/4 per cent upper limit on the Federal funds rate, and he hoped it would not move much above 5 per cent during the coming period. If the Committee was going to set a target for growth in RPD's he would favor a range for the September-October period of 11 to 15 per cent, although he was impressed with the difficulties of making any RPD projections at this time in view of the scheduled implementation of the changes in Regulations D and J. In that connection, he thought the directive language should reflect the present uncertainty as to whether those regulatory changes would actually be put into effect. Finally, the Manager would have to have

maximum leeway during the coming period and might, for a time at least, have to rely on the funds rate for his principal guide.

Mr. Daane said his response to the Manager's question was that the Desk should not be at all relentless in pursuing specific targets for the aggregates during the period immediately ahead. Like others, he would prefer to see somewhat more moderate growth in the aggregates. However, he thought the Manager would need maximum latitude in the coming period in light of the prevailing uncertainties as to the degree of the vulnerability of the market and the reserve impact of the changes in Regulations D and J, assuming they were implemented. It was particularly important at this time that open market operations should not tend to confirm the market's view that the System planned to rush up the hill with interest rates.

Mr. Daane noted that market participants watched the funds rate closely for clues to the System's policy intentions. The Manager had suggested that the market probably could tolerate a funds rate a little above 5 per cent without undue reactions. If the rate were to rise as high as 5-3/4 per cent in the next few weeks, however, he (Mr. Daane) would expect interest rates to be off to the races. The difficulties would be enhanced by the Treasury's cash financing next month, and that would be so even if the financing took the least unsettling form of an issue of tax-anticipation bills.

In his judgment, Mr. Daane continued, the Desk should be concerned with the "tone and feel" of the market. On the basis of long and close contact with open market operations during his 34 years with the Federal Reserve System, he was still persuaded that there was real meaning in that concept. He would like to see the Desk probe upward with the Federal funds rate, backing and filling and feeling its way, in an effort to achieve somewhat slower growth in the aggregates without giving the market the sense of certainty about System intentions that would precipitate an upward ratcheting of interest rates generally.

Mr. Daane remarked that he would prefer a directive cast in terms of money market conditions. As to specifications, those shown under alternative B were probably most nearly consistent with the prescription of cautious probing that he favored. As was often the case, however, he found it difficult to assess the significance of the alternatives shown for growth rates in the aggregates. For the fourth quarter, for example, the annual rates of growth shown under alternatives B and C differed by only one-quarter of a percentage point for M_1 and by only one-half of a point for M_2 and the bank credit proxy. His confidence in the accuracy of the staff's projections was not great enough for him to advocate one pattern of growth rates over the others when the differences were that small.

Mr. Daane then said he might add some comments regarding the discount rate, without prejudging how as a member of the Board he would vote on any actions that might be proposed by the Reserve Banks. At the moment he was concerned that a discount rate increase would be interpreted as leading the market toward higher interest rates, and that it would have the same kind of undesirable effects as a large rise in the Federal funds rate. More generally, he disagreed with Mr. Morris regarding the desirability of tying the discount rate closely to market rates. In his judgment there were times--and this was one of them--when there was positive merit in a discount rate that was out of line with market rates, because it could then serve as a drag on market rates and reduce the risk of sharp upward surges.

Mr. Mitchell observed that the discussion so far revealed considerable sentiment for "gradualism." That term had been highly popular when the present Administration took office 4 years ago with the stated objective of applying economic stabilization measures in a gradual rather than abrupt fashion. One problem with a gradualist approach was that it took so long to become effective that everyone became unhappy over the lack of progress. Another was that it exposed policy-makers to such criticisms as "Why have you begun to restrain economic activity when unemployment is as high as it is today?" While such criticisms could be

answered with explanations about the lags in the system, the explanations often would be convincing only after the fact; earlier, the policy-maker was forced to admit that no one could say how long the lag would prove to be in a particular case. Thus, it was much easier to defend a move toward restraint after concrete evidence of the need for it was in hand.

Mr. Mitchell noted that Chairman Burns had suggested today that the Committee had already embarked on a course of gradual restraint. Perhaps the Chairman was right, but he (Mr. Mitchell) would not have placed that interpretation on recent policy. It was his view that the Committee had moved into an accommodative stance and was still in such a stance. And he thought that was the better place to be at the moment.

Mr. Mitchell observed that several speakers today had referred to the staff's GNP projections and econometric model in support of the policy course they favored. He might note that the model had a number of defects. For one thing, it did not take into account the nature of future actions by the Pay Board and the Price Commission. For another, it incorporated highly uncertain assumptions about fiscal policy. And for a third, it did not take account of the effects of the scheduled changes in Regulations D and J, because no one could be sure at this point what those effects would be.

Perhaps the model took account of market expectations in some manner, Mr. Mitchell continued. In any case, that was a subject with which the Committee had to be concerned, since the market's assessment of the System's intent could have important consequences. In the area of open market operations--unlike that of discount rate actions--the System had a choice as to whether to offer a signal of policy intent. At this point he would not want to signal a Federal Reserve judgment that tightening should occur. He would not object strongly if market forces themselves were creating tighter conditions, but he thought the System should not be leading the trend. In his judgment the difficulties experienced around the Labor Day weekend had arisen because the market interpreted System operations as signaling a move toward firmer conditions in reaction to high growth rates in the aggregates. At present, the Committee did not--and could not--know what would happen to the aggregates in the months ahead, partly because of uncertainty about the consequences of the changes in Regulations D and J.

In view of that uncertainty, Mr. Mitchell remarked, he agreed with those who thought the directive should be formulated in terms of money market conditions. The language Mr. Coldwell had proposed might be acceptable, perhaps with some minor modification. Like some others, he had difficulty in choosing among

the alternative sets of specifications, but if he had to make a choice it would fall between those given under alternatives B and C.

As to the discount rate, Mr. Mitchell said he would prefer not to make a change at this time if one could be avoided, because that also would transmit a kind of signal. He thought, however, that the point at which a change was needed might already have been reached--or soon would be--if the System followed the course of keeping the discount rate reasonably in line with market rates. He agreed with Mr. Morris that the discount rate should not be permitted to get far out of line with the market, and he thought there were circumstances in which a quarter-point increase would be a neutral action in the sense that it would be interpreted as catching up with rather than leading the market. On that basis a near-term increase of a quarter-point might be relatively harmless, and he probably would not find himself strenuously opposing such an action should it be proposed. As he had indicated, however, he would prefer on balance to avoid a rise at this time if possible.

Mr. Sheehan noted that during the first quarter of 1972 the Federal Reserve had not reduced the discount rate from its 4-1/2 per cent level despite a decline in short-term market rates well below that level. He asked whether Mr. Mitchell thought the

System's failure to lower the discount rate then had created any difficulties.

Mr. Mitchell replied that in his judgment the System was almost always better off when it kept the discount rate in line with the market. If the recent practice of some commercial banks in tying their prime rates to market rates proved to be successful, he thought it might offer a splendid example for the System to follow. He agreed with Mr. Daane that there were times when it might be desirable to deviate from such a course, but he disagreed that this was such a time.

Mr. Sheehan asked whether Mr. Mitchell thought the System's inaction last spring had kept market rates from falling as far as they otherwise would have, and similarly, whether inaction now would tend to moderate upward pressure on market rates.

Mr. Mitchell replied that he doubted that there had been much rate effect in the spring; the major consequence of holding to a 4-1/2 per cent discount rate then had probably been that of leading people to wonder why a reduction had not been made. The consequences of inaction at present would depend on the interpretations the market placed on the objectives of open market operations. He thought observers were puzzled about those objectives at the moment. They probably would remain puzzled if the discount rate was kept unchanged and the Federal funds rate was held within a range of, say, 4-7/8 to 5-1/4 per cent.

Mr. Hayes observed that it was the almost unanimous view of people in the New York financial district that short-term rates were in a rising trend.

Mr. Mitchell remarked that it was precisely that attitude which he thought the System should try to modify. The System had weakened in that effort around the Labor Day weekend; if it had not, such expectations would not have fed on themselves.

Mr. Hayes remarked that the view he mentioned was not attributable to developments during the past few weeks but had developed earlier.

Mr. Kimbrel expressed the opinion that a move toward some moderate slowing of the monetary aggregates was overdue. It seemed to him, however, that just as there were times when circumstances called for policy to be aimed primarily at aggregate objectives, there were other times when primary emphasis should be placed on money market conditions. At present, in view of the many uncertainties and technical unknowns, it could be argued that the Committee's main concern should be to provide member banks with adequate reserves to make the necessary adjustments and to avoid sharp changes in short-term rates. Thus, it might be appropriate to place primary emphasis on money market conditions in the period until the next meeting of the Committee. Personally, he favored seeking somewhat firmer money market conditions in this

period, but he thought the conditions associated with alternative C represented about as much firming as the Committee could expect to accomplish. He would grant the Manager the latitude to cope with possible market problems, but hoped there would be a minimum of slippage in money market conditions.

Mr. Kimbrel noted that there had been a spirited discussion of the discount rate at the last meeting of the executive committee of the Atlanta Bank's board. The conclusion was that an increase in the discount rate would not be desirable at the moment in view of the impending changes in Regulations D and J. Also, the directors would prefer to follow the market rather than lead it, and they were not sure that an increase now would be clearly a following action; and they certainly would not want to signal an overt change in the System's stance at this time.

Mr. Robertson said he was concerned about inflation and about the need to purge the economy of inflationary expectations. That, in his judgment, was the most important problem facing the System now. At its last meeting the Committee had set guidelines for the Manager's operations, but as soon as the Manager had begun to tighten up on the provision of reserves and the growth rates of the aggregates he had been compelled to beat a hasty retreat by developments in credit markets. The Manager had found himself in a very difficult situation, and his actions were justified under

point 3 of the points for his guidance, which indicated that the Federal funds rate was to move in an orderly way and was not to bounce around unchecked within the specified range. Nevertheless, the recent experience was an unfortunate one.

Mr. Robertson expressed the hope that the Committee would learn from that experience, rally its forces, and try again. To sluice in all of the reserves necessary to hold interest rates down would be to foster growth in the monetary aggregates at a pace that would finance a new round of inflation. The Committee should not attempt to hold down interest rates but should utilize its powers to moderate inflation. In his judgment, that required moving now; he would not wait.

Specifically, Mr. Robertson continued, he would direct the Manager to pull back on the rate of growth in RPD's and the monetary aggregates to the fullest extent possible without permitting the funds rate to rise above, say, 5-1/2 per cent, and the bill rate perhaps not above 5-1/4 per cent, in the period before the next meeting. As he read the alternatives for the directive, he thought C would fit such a course more closely than the others.

In a concluding observation Mr. Robertson said he thought the Committee should not be too sensitive to interest rates. Rather, it should let market forces play their full part and should limit itself to moderating sharp movements.

Mr. MacLaury said he would begin by indicating why he thought the Committee should move now to restrain growth in the monetary aggregates rather than delaying further. First, September was the third successive month of monetary growth in excess of earlier expectations. Also, an arithmetic calculation like that cited by Mr. Morris revealed that growth in M_1 over the year 1972 would exceed 8 per cent even if the Committee today adopted alternative D--the most restrictive of the 4 alternatives presented in the blue book and one for which he held no particular brief. And it was worth noting that the staff's projections for the first quarter of 1973 were now stronger than 4 weeks ago; thus, a 6 per cent growth rate was anticipated in the first quarter under alternative D, in contrast to the 4-1/2 per cent pace projected in the previous blue book on the basis of a roughly similar assumption for the Federal funds rate. It was quite likely that such upward revisions would be found necessary for successive quarters of 1973--at least if the current assessment of the strength of the economy proved correct, as he thought it would.

Despite such considerations, Mr. MacLaury remarked, it was obvious that the Committee did not have to act in any particular month or in any particular quarter. But it was equally obvious that the Committee should not rely on that fact to postpone

action at meeting after meeting. Moreover, the present meeting offered a better opportunity for action than later ones would, in view of the prospects for Treasury financing operations over the period through early 1973. And action now would, of course, not commit the Committee to continuous firming; if it turned out that the blue book projections of the aggregates were too high and those of the New York Bank were nearer the mark, policy could be modified at subsequent meetings.

As to the nature of the action to be taken, Mr. MacLaury said that this was a time--if there ever was one--for temporarily setting aside RPD targets, in view of the uncertainties associated with the scheduled changes in Regulations D and J. He favored focusing on money market conditions in the coming period, and he found the directive language proposed by Mr. Coldwell to be particularly attractive. He would formulate the Desk's instructions in terms of a point target for the Federal funds rate; while the Desk could not be expected to hit such a target precisely, it could be expected to come reasonably close--certainly closer than to a target growth rate for a monetary aggregate. He agreed with Mr. Daane that it would be a grave mistake to have the funds rate rise to the area of 5-3/4 per cent at present, but he thought a target rate of 5-3/8 per cent, to be attained on average in the coming period, would be appropriate. Unlike Mr. Daane, however,

he thought the Desk should be a little more relentless than it had been in the recent period in pursuing the targets set for it.

Mr. MacLaury said he concurred in the Manager's view that it might be desirable in the coming period for the System to buy longer-term bills or other specific issues which were a drag on the market, and offset the reserve impact by selling short-term bills. Such operations could be helpful in easing pressures at particular points of the maturity structure and, more generally, in attaining the Committee's objectives without exacerbating problems in the market.

As to the discount rate, Mr. MacLaury observed that he had been advising the directors of the Minneapolis Reserve Bank that an increase was neither necessary nor desirable at this time. He thought they agreed that the balance of considerations argued against an increase, even though--like Mr. Mitchell and others--they would be happier if it were possible to keep the discount rate in line with market rates.

Mr. MacLaury then said he might comment on certain earlier observations by Mr. Mitchell and Chairman Burns. In his remarks on gradualism, Mr. Mitchell had suggested that it would be difficult for the System to justify beginning to firm gradually now, considering the level of the unemployment rate. He (Mr. MacLaury) would make the opposite point that, considering the change in circumstances

over the past 2 months, it was difficult for the System to justify its failure to produce any net firming of money market conditions in that interval. He noted in that connection that the average Federal funds rate was 4.61 per cent during the statement week ending July 5 and nearly the same--4.69 per cent--in the latest statement week, ending September 13. Although Treasury bill rates had risen considerably over the same interval, he would attribute their rise primarily to the fact that they had been depressed earlier as a result of special factors.

Continuing, Mr. MacLaury said the Chairman's remarks on which he wished to comment were those relating to the implications of changes in interest rates--along with changes in prices, profits, and dividends--for the nature of the decisions to be taken by the Pay Board. He agreed that those implications posed a potentially serious problem which should be taken into account in formulating monetary policy. As the Chairman had noted, however, the interest rates that mattered most in that connection were those on mortgages and on consumer loans. While efforts might be made to see that such rates did not rise abruptly, he thought short-term market rates would still be free to rise. In particular, he would not expect an increase during the coming 4 weeks of the magnitude he was proposing--about 3/8 of a point in the Federal funds rate--to have significant adverse effects of the kind under discussion.

Chairman Burns said he had not planned to comment further until the remaining members had expressed their views on policy. In light of Mr. MacLaury's concluding remarks, however, he might say a word at this point about the Committee on Interest and Dividends, which as the members knew was a Government-wide Committee including only one representative from the Federal Reserve Board. A rather strong body of sentiment was developing within that Committee in favor of a public statement admonishing lenders in all categories to act prudently in setting interest rates, and suggesting gently--but still suggesting--that if they failed to do so the Committee would establish guidelines for interest rates. The proposal for such a statement was facing some opposition, but it might be approved. If guidelines were established the result would be a confrontation between the Federal Reserve and the Executive establishment--a prospect that was extremely disturbing.

The Chairman went on to say that the policy views of each of those who had spoken thus far seemed reasonable, in the sense that they were justified in terms of the speaker's own view of the future. The difficulty was that visions of the future were so clouded. His own position was complicated not only by the role he played on the Committee on Interest and Dividends but also by the fact that he had had a certain influence in moving

the Ways and Means Committee of the House of Representatives towards a ceiling on Federal expenditures. One of his arguments had been that in the absence of an expenditure ceiling interest rates would rise significantly, and that the Federal Reserve would be unable to check the rise even if it wanted to do so. He might add that he had just been asked to testify tomorrow morning in an executive session of the Ways and Means Committee.

As Mr. Heflin had suggested, the Chairman observed, the problem was an all-Government one. The Federal Reserve had to discharge its own responsibility, but in doing so it had to take account of what was being done and planned and thought elsewhere within the Government.

Mr. Winn left the meeting at this point.

Mr. Sheehan referred to Mr. Mitchell's comments on gradualism and noted that when he had joined the Committee in January his thinking on policy had tended to run in terms of a gradualist approach. At that time the Federal funds rate had been about 3-1/2 per cent; since then it had risen by about a half of a percentage point per quarter. With respect to the comments of Messrs. Daane and Robertson today, it was interesting to note that despite the difference in their policy views they both seemed to be approaching the same thought with respect to the market. Thus,

Mr. Daane had urged that the Committee not confirm the market's view that the System was rushing up the hill with respect to interest rates; and Mr. Robertson had urged that market forces be permitted to play their full part.

Mr. Sheehan then observed that he had been surprised by the magnitude of the movement in interest rates following the preceding meeting. In particular, he had been startled by the level the funds rate had been permitted to reach before the Labor Day weekend without further consultation with the Committee. Apparently, his understanding of the Committee's expectations and instructions at the preceding meeting had differed from that of others.

Continuing, Mr. Sheehan remarked that he did not perceive the exuberance in the economy that others did; indeed, he was a little surprised by the Chairman's views on the strength of the economy. On the basis of discussions with a number of industrialists and bankers in Boston last night, he would now question whether any significant stimulus could be expected from inventory investment. For example, the head of one large corporation had indicated that his company did not plan to increase inventory investment; that it had developed the tightest and best inventory controls it had ever had, and was now able to fill 95 per cent of its orders without difficulty. The same kind of development

appeared to be occurring elsewhere. Earlier in the year he (Mr. Sheehan) had thought that businesses were simply moving slowly in adapting their inventory policies to the upturn in activity, but he no longer believed that was the case.

More generally, Mr. Sheehan said, against the background of the staff's projections of GNP and industrial production, and with the unemployment rate at 5-1/2 per cent, he did not see a need for sharp increases in short-term interest rates. Rather than lead market rates up, he would prefer to maintain a sense of uncertainty about the course of System policy. He favored alternative B, and during the next 4 weeks he would like to keep the Federal funds rate in the range Mr. Mitchell had mentioned--4-7/8 to 5-1/4 per cent.

Mr. Bucher said that like other Committee members he was getting a little worried about the growth rates of the monetary aggregates and was inclined toward Mr. Brimmer's views on that subject. At the same time, from his experience before joining the Committee he was well aware of the relationship between market psychology and interest rates, and he understood the need for sometimes moving cautiously to avoid creating undesired market reactions. He might also note that he had learned in his few months on the Committee that the projections made by the staff--both at the Board and the New York Bank--were not as

infallible as he might have thought earlier when he was an outsider.

Evidently, Mr. Bucher continued, the Committee had posed a problem for the Manager at the previous meeting by giving him specifications for the aggregates and for money market rates that proved to be inconsistent. Today, if everything else were equal, he would prefer the interest rate specifications of alternative A and the aggregate growth rates of D; but, of course, other things were not likely to be equal. On balance, he would opt for the growth rates of alternative C, and he would be willing to accept a Federal funds rate as high as 5-1/2 per cent in the coming period. If the specifications for the funds rate were to be set in terms of a range--as might be desirable in light of the risk of undue market reactions--he would favor the range of 4-3/4 to 5-1/2 per cent. Like Mr. MacLaury, however, he saw advantages in a point target; certainly, if he were the Manager he would prefer working with a specific target rather than a spread. If a point target were to be used he could accept 5-3/8 per cent but would prefer a lower figure.

Mr. Clay observed that the monetary policy problem today was an intensification of the similar problem the Committee had faced at the last meeting. In his judgment monetary policy was excessively stimulating and needed to be restrained. It was not

reasonable to expect that the Committee could reduce the growth rates of the monetary aggregates to an appropriate degree without having interest rates move upward. Allowing excessive growth rates in the aggregates to avoid upward movements in interest rates only aggravated the problem. To be sure, it was important in his opinion that whatever adjustment in interest rates did take place should be gradual rather than abrupt.

All factors considered, Mr. Clay said, alternative C of the draft directives appeared to be the best choice today, although if growth paths for the monetary aggregates were considered alone those of alternative D would be more desirable. He would favor giving the Manager a good deal of leeway to avoid unduly abrupt changes in interest rates.

Mr. Clay added that in his judgment a quarter-point increase in the discount rate was justified at this time on both economic and market grounds. Such an action, in his view, would not constitute leading the market, and it would have the advantage of keeping the discount rate within striking distance of market rates. He remembered a previous episode in which the discount rate was far below market rates for an extended period. System officials were in agreement that the discount rate was much too low, but in view of the size of the increase that would have been required to bring it into line with the market, they considered it necessary to delay

an increase until market rates had declined enough to narrow the gap. It was with that recollection in mind that he favored an increase now.

Mr. Merritt noted that at other recent meetings he had favored a move toward slowing the expansion in the aggregates. He was of the same view today, but in light of the uncertainties about the effects of the amendments to Regulations D and J--assuming they were implemented--he would now want to move with less speed than he would have urged earlier. For the same reason, he would prefer to cast the Desk's instructions in terms of money market conditions.

Specifically, Mr. Merritt said, he thought the Committee should formulate its primary target in terms of a range for the Federal funds rate, and instruct the Manager to probe within that range while granting him a great deal of latitude. Earlier, he would have considered 5-1/2 per cent acceptable as an upper limit for the funds rate, but given present circumstances he would not like to see the rate rise above 5-3/8 per cent during the next few weeks. For the lower limit he would suggest 4-7/8 per cent.

With respect to the discount rate, Mr. Merritt observed that while he generally favored keeping that rate as closely in line with the market as feasible, he thought the period immediately ahead might not be a good time for an increase. The volume of

member bank borrowings would influence his attitude to some extent. Borrowings on the order of $500 million probably could be tolerated without a rate change. However, if an increase in the funds rate to 5-1/4 or 5-3/8 per cent was associated with a rise in borrowings into the $600 to $800 million area, an increase in the discount rate might very well be justified.

Chairman Burns said he might make a few observations before attempting to derive the Committee's consensus. He had been keeping a close watch on the aggregates, and had been highly disappointed by what he had observed. He had been watching interest rates, and had been very much disappointed by developments in that area also. The question was how to balance one against the other. He wondered, however, whether there was a full appreciation of the extent to which interest rates had risen thus far in 1972. According to the blue book table labeled "Selected Interest Rates," the increases in average rates from the month of January to the latest statement week, in terms of basis points, were as follows: Federal funds, 119; 90-day Treasury bills, 134; 1-year bills, 157; 90-119 day commercial paper, 97; AAA corporate new issues, 25; municipal bonds, 26; and 10-year Governments, 60. The only rate series in the table that had been essentially stable was the FNMA auction yield. There had been some movement in other mortgage interest rate series, but not very much. If there was merit in the staff's

belief that changes in interest rates had a lagged effect on growth rates in the monetary aggregates, forces had already been released that should be serving to moderate those growth rates. The magnitude of that effect was highly uncertain, however, and that produced a dilemma for the Committee.

As to the views of members on policy, the Chairman continued, it appeared from the discussion that a majority favored alternative C and that a substantial minority favored B. Postponing the question of specifications for the moment, he would suggest that for the operational paragraph the Committee consider the language of alternative C with one small but significant modification. The modification he had in mind was the addition of the word "special" before "account" in the second clause, making the beginning of the paragraph read "To implement this policy, while taking special account of developments in credit markets, international developments, and the effects of bank regulatory changes . . . ." The purpose of the change was to emphasize that, partly because of the sensitive state of credit markets and partly because of the uncertainties regarding the reserve effects of the impending bank regulatory changes, money market conditions were to be given special importance and the Desk was to have more than the usual degree of flexibility. He asked whether alternative C, so modified, was considered satisfactory by the Committee for the operational paragraph.

After discussion, it was agreed that the proposed modification was satisfactory.

Mr. Mitchell suggested that the reference to bank regulatory changes be placed ahead of the reference to credit market and international developments, so that the ordering would be in accordance with the probable relative importance of the three types of factors.

Mr. Robertson observed that it might also be desirable to qualify the reference to bank regulatory changes to take account of the uncertainty as to whether they would in fact become effective in the coming period. As the Committee knew, Federal court hearings on Regulation J were under way today in both Washington and Los Angeles.

Mr. Holland said he had just received word that the U.S. District Court for the District of Columbia had issued a temporary restraining order preventing the Board from implementing the amendments to Regulation J for the time being.

After further discussion, it was agreed that the operational paragraph of the directive should read as follows: "To implement this policy, while taking special account of the effects of possible bank regulatory changes, developments in credit markets, and

international developments, the Committee seeks to achieve bank reserve and money market conditions that will support more moderate growth in monetary aggregates over the months ahead."

The Chairman then said he would propose a particular interpretation of that language, including a set of specifications, which appeared to him to be a reasonable compromise of the members' views. For RPD's, for which the average annual rate of growth in September and October shown under alternative C was 13.4 per cent, he would suggest specifying a range for that period of 11-1/2 to 15-1/2 per cent. For the Federal funds rate the range would be 4-3/4 to 5-3/8 per cent. For the monetary aggregates, the specified rates would be those of alternative C--for M_1, 11-1/2 per cent in September and 7 per cent in the fourth quarter; the same for M_2; and for the adjusted credit proxy, 9 per cent in September and 11 per cent in the fourth quarter. Those growth rates would not be considered as targets, but as what might be called "guiding" figures, in the following sense: if the Manager assessed incoming data as confirming the high rates projected, he would have the authority to move the Federal funds rate towards the upper end of the indicated range. On the other hand, if the aggregates appeared to be considerably weaker, he would be expected to hold the funds rate unchanged or perhaps edge it down in the range.

Finally, the Chairman said, it would be understood that in light of the special circumstances now prevailing the Manager would pay more attention to money market conditions than customarily, and he would have greater latitude than in any other period so far this year. And if firming actions were required, they would be carried out with discretion, and not so evenly as to convey an obvious policy signal.

In response to a question, Mr. Holmes said the Desk had been aiming at a funds rate of 5 per cent in recent days, and the rate had been about at that level yesterday. This morning it had been tending up toward 5-1/4 per cent and the Desk had been resisting the movement.

Mr. Holmes then noted that the Chairman had used the blue book projections in formulating the proposed specifications. He presumed from the discussion that Committee members would be pleased if M_1 actually grew in September at the 6-1/2 per cent rate projected by the New York Bank staff on the assumption of no change in money market conditions.

Chairman Burns remarked that he personally would be even more pleased if the September growth rate were 4 per cent.

Mr. Holmes said he assumed the Committee would not want him to reduce the funds rate from existing levels if M_1 did in fact appear to be growing at a 4 per cent rate.

Chairman Burns said that would be his interpretation also. However, if M_1 were still weaker--say, not growing at all or perhaps at a 1 per cent rate--he thought the Manager would want to consider moving toward the lower end of the range, depending on how the markets were behaving.

Mr. Mitchell asked whether the policy course under consideration had direct implications for the discount rate. While views on the matter differed, he would be somewhat troubled if rising market rates opened a large gap above an unchanged discount rate, since he thought there were limits to the extent to which the latter could be permitted to lag. As had already been mentioned, the discount rate had been held above market rates for a considerable period earlier this year, but that had not posed any great problem because market rates had been expected to move back up. Now, however, a large gap was likely to create greater problems because there would be widespread expectations of a continuing rise in market rates.

Chairman Burns observed that he, for one, was not prepared to express an opinion on the discount rate today, other than that he was not eager for an increase.

Mr. Brimmer said there was some question in his mind as to whether the lower limit for the funds rate should be set at 4-3/4 per cent, as the Chairman had suggested, or at 4-7/8 per

cent, which was closer to the prevailing level. What concerned him particularly was the risk of further slippage in working toward the objective of moderating growth in the aggregates.

Mr. Daane expressed the view that the slightly wider range suggested by the Chairman was consistent with the proposal that the Manager should be given increased latitude in light of prevailing uncertainties. So long as the Committee's objectives for the aggregates were clear to the Manager, it would seem undesirable to narrow the range for the funds rate and thus reduce the Manager's flexibility to back and fill as he worked toward those objectives.

Mr. MacLaury said it might be helpful to distinguish sharply between the two different kinds of uncertainty involved in the discussion today. One was the uncertainty associated with the scheduled changes in Regulations D and J. In his judgment, by having the Manager focus on money market conditions for this period, the problems arising from that source could be dealt with effectively, and accordingly they could be set aside. The second kind of uncertainty related to the possibility of undesirable market reactions to any firming operations by the System. That could be dealt with by instructing the Manager to use a probing approach in any firming operations, standing ready to back off if the market reaction indicated that he was moving too fast. As he (Mr. MacLaury) had indicated earlier, he would favor instructing

the Manager to probe toward a funds rate of 5-3/8 per cent--not as a ceiling but as an average level during the coming period. Under such an instruction, no lower limit for the funds rate would have to be specified.

Chairman Burns said he wanted to make it clear that he would much prefer not to see the funds rate rise to 5-3/8 per cent in the coming period. He would be willing to tolerate a 5-3/8 per cent rate if required by circumstances, and he had proposed specifications under which the Manager would have the authority to move to that level. But he definitely did not want to press eagerly toward higher funds rates regardless of other circumstances.

Mr. Robertson said he also would not favor pushing up the funds rate aggressively without regard to the performance of the aggregates or other circumstances. But he did want to slow the growth in RPD's and the aggregates--to the extent that could be done without causing undesired reactions in the market--and he believed that a higher funds rate was required for the purpose. Accordingly, he thought the Desk should be instructed to move the funds rate up in an orderly way toward 5-3/8 per cent. He saw no need to specify a floor for the funds rate.

Mr. Hayes asked whether it would be contemplated under the specifications the Chairman had proposed that the Desk would raise the funds rate to 5-3/8 per cent over the period until the

next meeting if the aggregates appeared to be growing at the rates now anticipated, and if firming operations were found to produce no particular problems in the market.

Chairman Burns replied affirmatively. He then proposed that the Committee vote on a directive consisting of the general paragraphs as drafted by the staff and the operational paragraph agreed upon earlier, with that directive to be interpreted in the manner he had outlined.

Messrs. MacLaury and Robertson indicated that they planned to cast dissenting votes.

Mr. Coldwell asked whether a favorable vote would imply an intent to validate growth in RPD's at a rate in the middle of the range the Chairman had mentioned, or, alternatively, whether the intent was to seek slower growth in RPD's--assuming no problems were encountered in the course of moving the funds rate up within the range specified for it.

The Chairman replied that the latter approach was the one he had intended.

Mr. Coldwell then said he planned to cast an affirmative vote.

Mr. Holland noted that Mr. Mayo would be called upon to vote as alternate for Mr. Winn, who had left the meeting earlier.

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

The information reviewed at this meeting suggests a substantial increase in real output of goods and services in the current quarter, although well below the unusually large rise recorded in the second quarter. In July and August, wages and prices advanced somewhat more rapidly on balance than in the immediately preceding months, while the unemployment rate remained substantial. Foreign exchange market conditions have remained quiet in recent weeks and the central bank reserves of most industrial countries have continued to change little. In July, the large excess of U.S. merchandise imports over exports persisted.

In August on average, growth slowed in the narrowly and broadly defined money stock and in the bank credit proxy, but in recent weeks the money stock has been expanding more strongly. Since mid-August, interest rates on Treasury bills have increased sharply, while yields on most other market securities have advanced more moderately.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to 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, while taking special account of the effects of possible bank regulatory changes, developments in credit markets, and international developments, the Committee seeks to achieve bank reserve and money market conditions that will support more moderate growth in monetary aggregates over the months ahead.

Mr. Holland noted that the specifications for RPD's shown in the blue book, including those for alternative C--on which the guiding range for RPD's approved by the Committee was based--reflected adjustments designed to take account of the effects of the scheduled

changes in Regulations D and J. He assumed the Committee would want the staff to make appropriate adjustments in that guiding range if, in fact, the regulatory actions did not become effective.

It was agreed that such adjustments should be made.

> Secretary's Note: The specifications agreed upon by the Committee, in the form distributed following the meeting, are appended to this memorandum as Attachment B.

> Secretary's Note: Following the meeting Messrs. MacLaury and Robertson each submitted summary statements of their reasons for dissenting from the directive, which they asked be incorporated in the record. Mr. MacLaury indicated that he had dissented because he had become increasingly disturbed by the rapid rates of growth in the aggregates, given the prospective strength of the economy, and he felt that the Committee's current operating procedures did not assure that money market conditions would be permitted to tighten sufficiently to slow this excessive monetary growth in the near future. Mr. Robertson dissented because of his belief that with the existing potentiality for increased inflationary pressures, the Committee was not doing enough to curb the rate at which reserves were being fed into the banking system by the Federal Reserve and to slow down the rate of growth in the monetary aggregates. In his view, the failure to do so might result in a new groundswell of inflation later on.

Chairman Burns then noted that a memorandum from the Secretariat dated September 12, 1972,[1/] set forth a tentative

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

Committee meeting schedule for 1973 which--like this year's schedule--called for twelve meetings at monthly intervals.

After discussion, it was agreed that the tentative schedule proposed was satisfactory.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, October 17, 1972, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

September 18, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 19, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests a substantial increase in real output of goods and services in the current quarter, although well below the unusually large rise recorded in the second quarter. In July and August, wages and prices advanced somewhat more rapidly on balance than in the immediately preceding months, while the unemployment rate remained substantial. Foreign exchange market conditions have remained quiet in recent weeks and the central bank reserves of most industrial countries have continued to change little. In July, the large excess of U.S. merchandise imports over exports persisted.

In August on average, growth slowed in the narrowly and broadly defined money stock and in the bank credit proxy, but in recent weeks the money stock has been expanding more strongly. Since mid-August, interest rates on Treasury bills have increased sharply, while yields on most other market securities have advanced more moderately.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonably equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPHS

Alternative A

To implement this policy, while taking account of developments in credit markets, international developments, and the effects of bank regulatory changes, the Committee seeks to achieve bank reserve and money market conditions that will support some moderation of growth in monetary aggregates over the months ahead.

Alternative B

To implement this policy, while taking account of developments in credit markets, international developments, and the effects of bank regulatory changes, the Committee seeks to achieve bank reserve and money market conditions that will support somewhat more moderate growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of developments in credit markets, international developments, and the effects of bank regulatory changes, the Committee seeks to achieve bank reserve and money market conditions that will support more moderate growth in monetary aggregates over the months ahead.

Alternative D

To implement this policy, while taking account of developments in credit markets, international developments, and the effects of bank regulatory changes, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead.

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

September 22, 1972

Points for FOMC Guidance to Manager In Implementation of Directive	SPECIFICATIONS (As agreed, 9/19/72)
1. Guiding rate of growth in aggregate reserves expressed as a range rather than a point target.	9-1/2 to 13-1/2% seas. adj. annual rate in RPD's in Sept.-Oct.[1/]
2. Range of toleration for fluctuations in Federal funds rate--enough to allow significant changes in reserve supply, but not so much as to disturb markets.	4-3/4 to 5-3/8%
3. Federal funds rate to be moved in an orderly way within the range of tolerance (rather than to be allowed to bounce around unchecked between the upper and lower limit of the range).	

4. Guiding expectations for monetary aggregates (M_1, M_2, and bank credit), to be given some allowance by the Manager as he supplies reserves between meetings.

	Sept.	3rd Q. (SAAR)	4th Q.
M_1:	11	10-1/2	7-1/2
M_2:	11	10	7-1/2
Proxy:	9	10-1/2	11

5. If it appears the Committee's various objectives and constraints are not going to be met satisfactorily in any period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.

1/ Modified from range of 11-1/2 to 15-1/2 per cent initially approved at 9/19/72 meeting, in order to allow for nonimplementation of changes in Regulations D and J.

ATTACHMENT C

Mr. Daane's Statement on September Basle Meeting

The Basle meeting of central bank governors on the weekend of September 9-10 was quiet and uneventful, which hopefully augurs for a similarly quiet and noncontroversial Fund and Bank meeting this next week. Actually, I think the governors in Basle were largely preoccupied with their next day meeting in Rome dealing with such questions as the establishment and scope of a European monetary fund.

The Sunday afternoon discussion was concerned largely with the question of central bank placements in the Euro-dollar market. This stemmed from German Finance Minister Schmidt's inclusion in his economic program of the matter of central bank placements in, or more accurately withdrawals from, the Euro-market. Much of the discussion centered on the possibility of an attractive investment outlet in the United States (either a "money employed account" at the Federal Reserve of New York or a new Treasury instrument) with a view toward also utilizing any such instrument to attract central bank funds of non-G-10 countries. After lengthy discussion, the governors charged the Standing Committee on the Euro-currency Market with taking a fresh look at the question of central bank placements, not only in terms of limiting further additions but also making withdrawals.

In the "tour d'horizon", principal interest focused on a renewed concern with inflation in a number of the countries represented and on the possible role of monetary policy in dealing with the problem. Governor O'Brien of the Bank of England indicated that the money supply growth for the first half of the year had been as high as 30 per cent and that inflation prospects were "not comforting". The German Bundesbank president had also talked about the need to reduce the rate of money expansion including the possible need for new instruments. The only other comment at the Sunday afternoon session which I might mention was that of the Japanese Deputy Governor, Mr. Inoue, who noted that their central bank had been supporting the dollar almost every day since the Smithsonian Agreement, and in the last two months had taken in around $1-1/2 billion.

At the Sunday night session of governors, President Zijlstra had returned to the question of achieving better control of the money supply, with a large number of the governors present expressing great

sympathy with both the objective and the need, if necessary, to develop new instruments to achieve adequate control. The consensus was that money supply growth was proceeding too fast, that monetary authorities should be able to find a way to control money supply growth, and that, if necessary, new instruments could or should be devised.

Two other housekeeping items deserve mention: (1) It was noted that there would be the usual meeting of central bank economists at the BIS November 9-11, with the topic being "The Effect of Exchange Rate Changes on Balance-of-Payments Developments--Experience in Recent Years (1967-72)". (2) It was noted that the BIS staff would continue to follow developments related to establishing a telecommunications system for effecting international payments (see attached "Note for the Governors").

Attachment

9th September 1972

Note for the Governors

Establishment of Telecommunications Systems for Effecting International Payments

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You will recall that, at your meeting in September 1971, it was decided that the computer experts of the central banks of the Group of Ten countries and Switzerland should study the possibility of using a communications system for effecting international payments similar to the one which was being studied at that time by the central banks of the EEC. In particular, it was suggested that they should contact commercial banks or banking associations considering establishing alternative networks with the aim of discouraging the development of a series of possibly incompatible telecommunications facilities.

As you were advised by a note dated 12th December 1971, contacts were established with the sole remaining major group effort in this area, the MSP (Message Switching Project). This is a body which initially involved 44 European and 25 American banks (now vastly more); it has completed a feasibility study on the technical, legal and administrative aspects of the matter and is committed to the establishment, possibly within the month, of an international organization to be named SWIFT (Society for Worldwide Interbank Financial Telecommunications), with headquarters in Brussels and incorporated in conformity with Belgian law.

The MSP Steering Committee declined the suggestion that the BIS represent the central banks of the Group of Ten countries and Switzerland in that Committee and invited the central banks and the BIS to join the proposed network merely as users on the same basis as the commercial banks in their respective countries.

This matter was reviewed at a meeting held at the BIS on 4th September 1972 and the majority of the Group decided to submit the following recommendations:

1. While the details of costs and possible membership rules remain unclear, on the basis of such information as is available, the majority of the Group recommends that the Governors agree in principle that central-bank participation in SWIFT is consistent with the general interest of such banks to improve the mechanism for effecting international payments in a timely and orderly manner. To this end it is proposed:

(a) that the central banks should join SWIFT and participate in their national groups (*) in order to follow and influence the development of SWIFT as a message switching mechanism, and

(b) that the Group continue to meet at the BIS to exchange information acquired at the national level and to formulate specific objectives to meet the interest of central banks, in particular to be able to develop as far as possible a common policy for the central banks as regards future developments in this field.

2. In addition to the participation of individual central banks in their national groups, it remains the unanimous wish of the Group, if appropriate terms can be arranged, that the BIS should represent the central banks or maintain a relationship with whatever international governing body might develop in SWIFT with a view to keeping the central banks informed as to the continuing development of that network.

Should the Governors agree to points 1 and 2 above as regards the central banks' participation in the SWIFT project, it is the belief of the majority of the members that it would be preferable to participate in the project from its inception.

3. The National Bank of Belgium, while agreeing with the usefulness of maintaining informal contacts in connection with SWIFT, believes that the central banks will not have the possibility of influencing it in becoming

(a) a general system open to all banks and financial institutions,
(b) a system which would enable central banks to benefit from its advanced technology by providing monetary authorities in the various countries with direct and primary data on international payments traffic,
(c) a system which takes into consideration the specific requirements of the EEC countries as a future monetary union.

(*) All central banks of the Group of Ten countries and Switzerland, with the exception, for different reasons, of the National Bank of Belgium, the Swiss National Bank, the Federal Reserve System and the Bank of Japan, have now paid the $3,200 for obtaining the documents from the MSP without taking any decision as regards future participation.