

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 Monday and Tuesday, December 17-18, 1973, beginning at 4:00 p.m. on Monday.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Balles
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Francis
Mr. Holland
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Sheehan

Messrs. Clay, Eastburn, Kimbrel, and Winn,
Alternate Members of the Federal Open
Market Committee

Messrs. Black, MacLaury, and Coldwell, Presidents
of the Federal Reserve Banks of Richmond,
Minneapolis, and Dallas, respectively

Mr. Broida, Secretary
Messrs. Altmann and Bernard, Assistant
Secretaries
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Sims, Associate Economist

Mr. Coyne, Assistant to the Board of
Governors
Mr. O'Brien, Special Assistant to the
Board of Governors
Mr. Keir, Adviser, Division of Research
and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International
Finance, Board of Governors

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Miss Pruitt, Economist, Open Market
Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat
Assistant, Board of Governors

Messrs. Boehne and Parthemos, Senior Vice
Presidents, Federal Reserve Banks of
Philadelphia and Richmond, respectively
Messrs. Hocter and Green, Vice Presidents,
Federal Reserve Banks of Cleveland and
Dallas, respectively
Mr. Kareken, Economic Adviser, Federal
Reserve Bank of Minneapolis

Chairman Burns noted that this afternoon's session had been called for the purpose of continuing the discussion, begun at the previous meeting, of the types of information on Committee targets to be included in the FOMC policy records. In the earlier discussion, he had suggested the possibility of publishing quantitative information on the short-run ranges of tolerance for M_1 , M_2 , RPD's, and the Federal funds rate and of formulating statements on the longer-run targets in qualitative terms. Subsequently, the staff had distributed excerpts from the policy records for the months from June through October of this year with changes illustrating how the texts might have been written in implementing that suggestion.^{1/} While he did not know how others judged the results of that experiment, he thought the proposed procedure yielded a better record than the present one,

^{1/} A copy of the staff's memorandum, dated December 11, 1973, and entitled "FOMC Policy Records," has been placed in the Committee's files.

in which quantitative information was given only for the highly volatile target ranges for RPD's. In particular, the evolution and direction of policy were more clearly indicated when all of the short-run specifications were reported in numerical form.

The Chairman noted that the Committee had considered a number of different alternatives at its previous meeting. In the interest of determining whether there was a consensus in favor of some particular procedure, the Committee might now hold a "go-around" in which each member would briefly indicate his preference. He invited Mr. Hayes to comment first.

Mr. Hayes said he certainly agreed that the procedure suggested by the Chairman and illustrated in the staff memorandum would be an improvement over the present practice of providing quantitative information only on targets for RPD's; the latter, he believed, was the worst alternative of all. However, his first choice would be to use qualitative language to describe all of the Committee objectives in the policy records, and to give more detailed information in a supplementary annual or semi-annual analytical review of objectives and results that would be published with a longer lag. If the policy records were to contain any quantitative information on targets, he would favor limiting that information to the longer-run objectives for the aggregates. His third choice

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would be to include both the short- and longer-run specifications, and his fourth choice would be to include only the short-run specifications.

Mr. Morris observed that he still held to the position expressed by Mr. Brimmer and himself in the report of the Subcommittee on Policy Records^{1/}--namely, that the policy records should contain the complete set of specifications which the Committee gave to the Manager. Accordingly, he would prefer to include the longer-run as well as the short-run targets in the records. However, he considered the compromise proposal offered by the Chairman to be a great step forward and he would support it.

Mr. Coldwell said he thought it would be unwise to publish either the short- or longer-run specifications in the policy records. In his judgment, the specifications were not in themselves policy actions and the Committee therefore was under no compulsion to report them. The monetary aggregates were now overemphasized to some extent, and the emphasis placed on them would be increased if the Committee's targets were regularly published. The new Subcommittee on the Directive, chaired by Mr. Holland, should have a free hand to make whatever recommendations it might wish, without being

^{1/} A copy of this report, dated October 11, 1973, has been placed in the Committee's files.

hampered by a new publication procedure. He concurred in the reasons the Chairman had advanced in a recent memorandum^{1/} against reporting the longer-run targets in the policy records, and he believed there were additional reasons for not reporting the short-run targets. In particular, the fact that the short-run targets frequently were not met was likely to lead to public misunderstanding in the absence of lengthy explanations which it would not be feasible to include in the policy records.

Mr. Balles remarked that the Chairman's compromise proposal would certainly be a great improvement over the present procedure. His first choice, however, would be to publish both the short-run and the longer-run targets. He recognized that, for reasons set forth in the discussion at the previous meeting, it might be necessary to introduce a 6-month lag for publication of the longer-run targets.

Mr. MacLaury said he would prefer to use qualitative language in the policy record descriptions of the Committee's objectives. In his view, the need to improve public understanding of the Committee's policy-making procedures would be best served by publishing an annual report that described those procedures in detail and included all of the quantitative targets

^{1/} A copy of this memorandum, dated November 15, 1973, and entitled "FOMC Policy Records," has been placed in the Committee's files.

adopted over the course of the year. If that course were not acceptable, he would favor publishing both the short-run and the longer-run targets in the policy records; the presentation of either alone was more likely to be misleading than helpful. The problems involved in the current publication of longer-run targets would be reduced if the policy-record lag were lengthened from 3 to 6 months, but that did not strike him as a practicable step. Accordingly, despite those problems, his second choice would be the publication of the full set of specifications with a 3-month lag.

Mr. Mayo agreed that the current procedure of publishing the specifications only for RPD's in the policy records was not a serviceable one. He thought it would be desirable to publish information on the longer-term paths for the monetary aggregates adopted by the Committee, with some accompanying explanation regarding the 6-month targets. In his judgment, such information could be released 90 days after the meeting without undue risk of market effects because it would be recognized that the targets were subject to change at every meeting. He still strongly believed that no useful purpose would be served by publishing the short-term targets in the policy records. Finally, he subscribed to the proposal for an annual review.

Mr. Clay said his position was similar to Mr. Mayo's. In his judgment the risk of divulging information about the likely future course of operations by publishing 6-month targets 3 months after their adoption could be dealt with by emphasizing that the targets were subject to change at each meeting. Moreover, he believed that observers would have great difficulty in determining the precise nature of the operations needed in the remaining 3 months to achieve the longer-run targets described in the policy records. If others did not agree with those judgments, he would favor publishing no quantitative information on targets in the records.

Mr. Black remarked that he found the question a difficult one because he saw merit in various views that had been advanced. Publishing only the longer-run targets, as suggested by Mr. Mayo, would have the advantage of making clear that the Committee was concerned about developments over the longer run and was not subject to the charge frequently made in the past that it suffered from "money market myopia." He had great sympathy for Mr. Daane's argument that publication of quantitative specifications would expose the Committee to a great deal of mistaken criticism. At the same time, he was impressed by the arguments Messrs. Brimmer and Morris had advanced for publishing the specifications in as complete a form as possible.

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On balance, Mr. Black continued, he favored the Chairman's compromise proposal, on the ground that it would give the public the maximum amount of information that could be revealed without providing clues to the likely course of future operations. That procedure would have the further advantage of illuminating the basic difficulty of achieving stable growth in the monetary aggregates without introducing substantial instability in the money markets. Many of the System's critics appeared to be insufficiently aware of the inherent conflict between the objectives of stable aggregate growth rates and stable money market conditions, and it would be helpful to have a better public understanding of the trade-offs which the Committee continually faced.

Mr. Daane said he still held to the position he had taken in the Subcommittee report, which was close to those expressed by Messrs. Hayes, Coldwell, and Mayo today. His first choice would be to eliminate from the policy records the quantitative information on RPD's now published, so that all statements on targets in the records would be formulated in qualitative terms, and to publish an annual review of operations with as much quantitative information as desired. If any quantitative information on targets was to be included in the records, he would strongly urge that it be limited to the longer-run paths, as proposed by Mr. Mayo.

In his view, Mr. Daane continued, the undesirability of publishing the short-run specifications was clearly demonstrated by the text for the October entry included in the staff's illustrative revisions of recent policy records to which the Chairman had referred. As rewritten, the text said that ". . .the Committee concluded that progress toward its longer-run objective of moderate monetary growth could be achieved if the aggregates expanded at somewhat slower rates in the short run. For the October-November period, therefore, the members adopted ranges of tolerance of 1 to 4 per cent and 5 to 8 per cent for the annual rates of growth in M_1 and M_2 , respectively. . . ." In fact, however, during that 2-month period M_1 and M_2 increased at rates of 7.8 and 11.0 per cent. He could see no useful purpose, from the point of view of the public, the financial markets, or the Federal Reserve, in publishing that kind of record.

Chairman Burns commented that the figures Mr. Daane had cited demonstrated that, at least in the month in question, the System's aim had been poor. Publication of those figures might stimulate suggestions for improving procedures. And if that performance could not be improved upon, he believed the public was entitled to have that information.

Mr. Daane observed that the Committee was not necessarily committed to its present approach to policy formulation.

The Chairman replied that the Committee also was not committed to any particular approach to the policy records. The decisions it reached today were subject to change at any time the members concluded that some other approach would be better.

Mr. Brimmer observed that he held to the position taken by Mr. Morris and himself in the Subcommittee report. He wanted to stress the point made there that the question at issue was how the Committee's instructions to the Desk should be reported, not how they should be formulated. In his view, the instructions should be reported in the manner in which they were formulated, whatever the latter might be. He was, however, prepared to accept the compromise proposed by the Chairman.

Mr. Sheehan remarked that he had a good deal of sympathy for Mr. Brimmer's position. He liked the Chairman's proposal, except that he would also favor publishing the 6-month targets with a 6-month lag. In general, he would prefer to publish as much information as possible as early as possible. In that connection, he noted that for the final meeting of the year the policy record had customarily been published with a lag of 2 rather than 3 months, without creating any particular market problems. At

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some point the Committee might want to consider reducing the lag for all of the records to 2 months, if that could be done without incurring substantially greater processing costs.

In a further observation, Mr. Sheehan said it was hard for him to believe that publication of the detailed specifications would result in more vocal criticism than the Committee's policy records were now receiving.

Mr. Bucher remarked that his inclination, like Mr. Sheehan's, was to publish as much information about Committee objectives as feasible, and as quickly as feasible. It was important for the public to know about the problems the Committee encountered as well as about its successes. He was willing to accept the Chairman's proposal for publishing only the short-run targets in the policy records as a first step, but he hoped the next step would be to include the 6-month targets as well. He was not particularly concerned about the risks, in terms of possible market effects, of revealing the 6-month targets with a 3-month lag, so long as it was made clear that the longer-run targets were subject to change at each meeting. And he was concerned that the Committee might only compound its problems by alluding to, but not revealing, its longer-run targets, since that was likely to encourage observers to speculate about their nature. His first

choice, therefore, would be to publish all of the specifications in the policy records.

Mr. Bucher added that he would like to stress a point that had been made earlier--namely, that full disclosure of the information in question could prove highly constructive by leading outside observers to make useful suggestions for improving Committee procedures.

Mr. Holland said he was inclined in principle to publish both the short- and longer-run targets in the policy records. If, however, the longer-run targets were omitted from the policy records it would still be feasible to include them in some kind of annual publication. Given the divisions persisting among Committee members after intensive consideration of the issue, it would be wise to proceed one step at a time. In his view the Chairman's proposal, as illustrated in the staff memorandum of December 11, was a useful and constructive step which he would be quite prepared to take now. The members' reactions, and those of outsiders, would help guide the Committee in any further steps, forward or backward.

Mr. Winn said he wanted to associate himself with Mr. Holland's view that publication of the short-run specifications in the policy record would be a useful first step. He

also agreed that additional material should be made available in an annual report. He would favor including in that annual report a discussion of the kinds of problems the System encountered in attempting to achieve its targets, in order to avoid the misunderstandings that otherwise were likely to result when the specifications were published.

Mr. Eastburn expressed the view that it was incumbent on the Committee to publish as much information on its targets as feasible, and to do so without long lags. He would be inclined to include both the short- and longer-run targets in the policy records, and to provide as full an analysis as necessary to make their meaning clear and to explain any inconsistencies that might develop among them.

Mr. Kimbrel said he agreed with those who thought the present practice of publishing quantitative information only on the targets for RPD's had not proved serviceable. He believed there would be advantages in publishing the longer-run as well as the short-run targets in the policy records. For one thing, providing information on the former would help place the misses with respect to the latter in proper perspective. For another, the exclusion of quantitative data on the longer-run targets might be viewed as an invitation to market observers and to the

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Congress to ask for the specific figures. However, he had a great deal of sympathy for the Chairman's proposal and considered it a highly satisfactory compromise at this point. He certainly agreed that it would be desirable to supplement the policy records with an annual review containing more quantitative information.

Mr. Francis observed that his preference would be to publish the full set of specifications in the policy records. He believed that the records should contain a clearer description of the whole process of making and implementing policy, including information on targets that were missed and on those that were hit. He would favor shortening the present 90-day lag in publishing the records by at least 30 days.

Mr. Mitchell said he had long felt that the Committee should formulate its policy decisions with the clarity offered by quantitative specifications. As he reviewed the record of recent years, however, he was forced to conclude that the efforts to do so had not been very successful; indeed, they may have led more to confusion than to anything else. Accordingly, he had considerable sympathy for the argument that the best course would be for the Committee at each meeting to call simply for tightening, easing, or no change in policy. Certainly, that was the safest course. To call for policy modifications of the fine

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degree indicated by small differences in numerical specifications implied that the Committee was able to make more precise determinations than it in fact could. Moreover, he did not believe that the specifications adopted by the Committee at each meeting were appropriate indicia of its intent; for example, when the Committee specified a 2-month range for the growth rate of an aggregate, it was simply expressing a judgment that growth within that range over the short run would be helpful in reaching the growth rate desired over the longer run.

For such reasons, Mr. Mitchell continued, he would not be disturbed if not all of the machinery involved in the specifications were revealed in the policy records. He looked forward to the day when the policy records could be as complete as Messrs. Morris and Brimmer desired, but he thought that day had not yet arrived. At the same time, he would not object to including the short-run targets in the policy records, along the lines illustrated in the materials the staff had prepared. As several speakers had noted, that would be an improvement over present procedures. The basic problem--that such records would not articulate the Committee's theory about the manner in which monetary policy worked--was a consequence of the fact that the Committee as a whole did not have such a theory, although individual members might. The solution to that problem had to be sought

in the area in which the Subcommittee on the Directive was working.

Mr. Hayes remarked that the degree of dissatisfaction with the System's ability to hit the short-run targets raised a question in his mind as to whether it was wise for the Committee to continue to specify such targets. The better course might be to limit any targets for the aggregates to longer-run objectives, and for the short run to concentrate on the degree of tightness or ease desired in money market conditions.

Chairman Burns observed that a diversity of thought had been revealed by today's discussion. It might be useful at this point to determine the number of Committee members and Reserve Bank Presidents not currently serving on the Committee who would find various possible courses acceptable, setting aside for the moment the question of the courses they would prefer.

The Chairman then described the following three alternatives with respect to the types of targets for which quantitative information would be published in the policy records: (1) all of the short-run targets, as in the proposal he had made earlier; (2) none of the targets; and (3) all of the short- and longer-run targets. With respect to the first alternative, he suggested that responses be considered to be without prejudice to the

question of whether quantitative information on the longer-run targets might be published with a longer lag.

In response to the Chairman's inquiry regarding the acceptability of each alternative, the number of affirmative responses was largest for the first alternative and smallest for the second.

Mr. Brimmer noted that the Chairman had not asked for expressions of view regarding the possibility of publishing the 6-month targets with a 6-month lag.

Chairman Burns commented that he personally had sympathy with proposals to make the 6-month targets public, either with a 6-month lag or in an annual review. He believed, however, that it would be best for the Committee to proceed cautiously, taking an initial step with respect to short-run targets now and considering without undue delay--perhaps in 2 or 3 months--whether to take a further step with respect to the longer-run targets.

In response to a question, the Chairman said he would not want to publish the longer-run targets with a 3-month lag in the policy records because that would provide information to market participants regarding the future course of policy that they should not have. Although in principle the longer-run targets were subject to change at each meeting, in fact they tended to

be relatively stable, and that would be quickly discovered by the market.

Mr. Mitchell said it had been argued that no one was given any special advantage when the same information was made available to everyone at the same time.

The Chairman observed that such an argument could be used to justify releasing information on the Committee's policy decisions immediately, rather than waiting 90 days. Even though a general publication nominally would leave all interested persons in the same position, some would be more alert than others to the availability of information about policy, and those who were less alert might be subjected to severe losses.

Mr. Morris said he had the impression from his own market experience that, regardless of the amount of information published by the System, the more sophisticated analysts were likely to arrive at better judgments regarding future policy than the less sophisticated. It was also his view that even the most sophisticated analysts could not make much use of information regarding, say, the 6-month target for growth in M_1 adopted by the Committee 3 months earlier. Market participants were directly interested not in monetary growth rates but in interest rates; in order to use such information on targets they would have to

decide not only whether the targets had been changed at intervening meetings but also what implications the target growth rates had for interest rates. That was not an easy calculation to make, as he was sure the staff would attest.

Mr. Kimbrel remarked that caution was needed with respect to the timing of the initial release of any additional quantitative information. With all of the uncertainties prevailing at the moment, he hoped the Committee could avoid contributing to the tensions existing in financial markets. It might be desirable to issue an advance announcement concerning the additional information that would be forthcoming.

The Chairman commented that he also had been troubled about that problem. If the Committee decided to begin publishing more quantitative information in some particular policy record, it could include an announcement to that effect in the press release accompanying the preceding record, issued a month earlier.

Mr. MacLaury said he would like to raise the possibility of taking a more cautious first step than including the short-run targets in the policy records. What he had in mind was the publication--perhaps, but not necessarily, in an annual report--of a detailed description of the Committee's whole policy-making

process. It would be possible in such a publication to discuss the problems inherent in the process and to explain why particular targets were hit or missed.

Chairman Burns said it appeared to be the sense of the Committee that more quantitative information should be included in the policy records.

Mr. Mitchell observed that there seemed to be a consensus among the members that the publication in the policy records of all of the short-run targets in quantitative form would be an improvement over the present procedure of publishing the figures for RPD's alone. He suggested that the question be resolved on that basis.

The Chairman then proposed that the members indicate whether they would prefer to have quantitative information included in the policy records on all of the short-run targets.

Chairman Burns and Messrs. Balles, Brimmer, Bucher, Francis, Holland, Mitchell, Morris and Sheehan responded affirmatively and Vice Chairman Hayes and Messrs. Daane and Mayo responded negatively.

Chairman Burns indicated that, in view of the majority sentiment, the staff would be instructed to begin including information on short-run targets in the policy records.

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Thereupon the meeting recessed until 10:00 a.m. the following morning, Tuesday, December 18, 1973. Committee attendance was the same as on Monday afternoon except that Mr. Francis was absent. Staff attendance was the same as on Monday except that Mr. Gemmill was absent, and the following were present:

Mr. Guy, Deputy General Counsel
Mr. Nicoll, Assistant General Counsel
Messrs. Andersen, Bryant, Eisenmenger, Gramley,
Reynolds, and Scheld, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open
Market Account

Mr. Melnicoff, Managing Director for Operations
and Supervision, Board of Governors
Mr. Feldberg, Secretary to the Board of
Governors

Mr. Pierce, Associate Director, Division
of Research and Statistics, Board of
Governors

Messrs. Wernick and Williams, Advisers,
Division of Research and Statistics,
Board of Governors

Mr. Pizer, Adviser, Division of International
Finance, Board of Governors

Mr. Ettin, Assistant Adviser, Division of
Research and Statistics, Board of
Governors

Mr. Wendel, Chief, Government Finance Section,
Division of Research and Statistics,
Board of Governors

Messrs. Taylor and Doll, Senior Vice Presidents,
Federal Reserve Banks of Atlanta and
Kansas City, respectively

Mr. Garvy, Economic Adviser, Federal Reserve
Bank of New York

Mr. Sandberg, Manager, Acceptance and Securities
Departments, Federal Reserve Bank of New York

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Chairman Burns noted that Mr. Francis was absent this morning because of the death of his father-in-law. Mr. Kimbrel, who was alternate to Mr. Francis on the Committee, would serve as a voting member for the rest of this meeting.

It was agreed that the Chairman would express the Committee members' sympathy to Mr. and Mrs. Francis.

The Chairman then observed that the Secretary had two recommendations to propose for implementing the Committee's decision of yesterday with respect to the content of the FOMC policy records.

Mr. Broida referred to a suggestion made during the discussion yesterday afternoon that advance public notice be given of the intention to include additional quantitative information about the Committee's targets in the policy records. Several senior staff members with whom he had consulted concurred in his view that it would be better to introduce the additional information without advance notice. Such notice would focus a great deal of attention on the forthcoming policy records and might create expectations of a more substantial innovation than was in fact contemplated. Secondly, he would recommend that the additional information be introduced with the policy record for the meeting to be held in January 1974. Following customary procedure,

the records for the November and December meetings would be released a day or two in advance of the Chairman's testimony before the Joint Economic Committee in February, and it would be desirable to preclude the possibility of an inference that the change in content had been made with those hearings in mind. Moreover, the first policy record of the new year--and the first to be included in the Board's Annual Report for 1974--would be a natural point at which to introduce changes in content.

There was general agreement with the two recommendations made by the Secretary.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on November 19-20, 1973, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on November 19-20, 1973, was accepted.

Chairman Burns invited Mr. Daane to report on the Basle meeting that he had recently attended along with Messrs. Mitchell and Coombs.

Mr. Daane remarked that at the outset of the formal meeting of the governors on the afternoon of December 10, at the request of President Zijlstra, Mr. Mitchell had made a lucid statement of the Board's current thinking on the regulation of foreign banks.

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The governors, although they had been given advance notice that he and Mr. Mitchell would be prepared to discuss the subject, in general had not focused on the substance of the issues. With respect to the issue of nondiscrimination, however, it was significant that the Germans apparently had changed their attitude. They said, in effect, that the United States already practiced discrimination by virtue of the large size of U.S. banks relative to the limited scale of foreign banks in the United States. They hoped that the United States would not prevent German banks from operating here in such a small way while branches of U.S. banks were fully accepted in Germany. According to their figures, U.S. banks obtained as much as 50 per cent of their earnings from foreign branches. In closing the discussion, Mr. Mitchell invited the governors to communicate directly to him or to Mr. Daane any further thoughts they might have on the subject.

Continuing, Mr. Daane said the usual "tour d'horizon" of those present was interesting and perhaps a bit curious. It began with a review of the Netherlands' position by President Zijlstra. Being asked where the measures taken by the Netherlands in reaction to the oil shortage left their partners in the "snake," he replied with some asperity that the measures left their partners with a substantial amount of the Netherlands' reserves.

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The theme expressed by many of the governors was the need for continuation of a restrictive monetary policy, although there were some doubts that the line could be held as the oil shortage began to disrupt economic activity. Therefore, the governors stressed that restrictive monetary policies should be maintained as long as possible, recognizing, however, that it might not be possible to maintain them for very long. Concerning the effects of the oil shortage on economic prospects, the Japanese reported that the 1974 rate of growth in Japan now was expected to be only 6 per cent compared with a rate of 11 per cent that had been expected.

Mr. Daane observed that in the evening session, President Zijlstra raised the question of whether in the present circumstances intervention in the exchange markets should be undertaken to prevent the dollar from appreciating too much. Although the discussion was inconclusive, opinion in general was against intervention because of the uncertainty as to the effect of the oil situation on the balance of payments of each country and, therefore, uncertainty as to what the "right" exchange rates were. Because of the uncertainties, some present had referred to the need to hold on to their dollar reserves for possible use in making payments for oil. The theme that emerged was that a

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return to the old system of intervention should be avoided and that such intervention as might occur should involve consultation and should be undertaken by the United States as well as by the European countries. He (Mr. Daane) spoke more favorably of intervention, reminding those present of all of their previous expressions of concern over the so-called dollar overhang. The new Managing Director of the International Monetary Fund, who attended the meeting, also supported the idea of intervening and reducing the dollar overhang.

Mr. Mitchell remarked that he would only add an interpretation of the attitude of the Germans and the British toward the operations of U.S. banks in their countries. Until now they had appeared to welcome U.S. banks to operate with the same rights and powers as their own banks, but some U.S. banks were now engaging in operations that had not been foreseen. At least two U.S. banks have set up organizations to attract indigenous deposits in Great Britain and Germany, and as a result, they had brought to the authorities' attention the fact that U.S. banks might gain a significant share of the banking business in those two countries. No such penetration had as yet occurred--although some German authorities seemed to think that it was taking place--but the possibility that foreign banks might have a role in their countries even as

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large as their own banks naturally shocked and disturbed them. The fact that domestic banks in those two countries had not been as aggressive in seeking consumer deposits as U.S. banks was leading to the prospect of a lively skirmish. Some forbearance on the part of U.S. banks might be required to avoid the imposition of constraints by host countries.

Mr. Brimmer commented that a modest relaxation of the VFCR program was likely in the near future in keeping with changes in the OFDI program. With respect to Mr. Mitchell's comments on the reactions of British and German authorities to the presence of U.S. banks, preliminary results of a survey of U.S. banks suggested that they looked to the United Kingdom and the continent for the future of their foreign banking business.

Mr. Mitchell commented that the only potential problem seemed to relate to the sweeping up of indigenous deposits by U.S. banks.

Mr. Morris, noting that the Germans had announced their intention to intervene in the exchange market if the mark reached 2.67 to the dollar, asked whether they no longer held to that policy.

In reply, Mr. Daane said the Germans had not been that precise with respect to intervention. In any case, perhaps as

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a result of conversations among the E.C. countries, the Germans now seemed to feel as strongly as the French that any intervention ought to involve the United States as well as the European countries.

Mr. Coombs added that German thinking appeared to have changed, but he was not sure what it now was. He had gotten the impression that the Germans might dig in to defend the mark at around 2.70 to the dollar--rather than 2.67, as Mr. Emminger had forecast--but in Basle, Mr. Klasen had indicated that the rate might be allowed to go to around 2.75. As far as operations in the exchange markets were concerned, only the Germans had indicated that they would welcome U.S. intervention in their currency. However, the view was expressed that, if the Europeans were called upon to defend their currencies, the United States ought to defend the dollar.

In response to a question by Mr. Mayo, Mr. Daane remarked that those present were in full accord with the decision to end the two-tier gold market, although the announcement of it by the United States had come a little earlier than they had expected.

Chairman Burns noted that in late November he had attended a meeting in France of the finance ministers of five major countries. The purpose of the meeting was to determine whether the five

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countries could reach a consensus with respect to international monetary reform so that the work of the Committee of Twenty might go forward. Although the organization of such a group provoked some unhappiness among countries not included, it probably was the only way that reform could be accomplished, and some progress had been made at the meeting.

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 November 20 through December 12, 1973, and a supplemental report covering the period December 13 through 17, 1973. Copies of these reports have been placed in the files of the Committee.

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

Since our last meeting, the dollar has remained buoyant, rising during the period by 3 or 4 per cent against the major European currencies, and it is continuing to improve today. The exchange market continues to regard the United States as less vulnerable than Europe and Japan to the Arab oil squeeze, and this is a major factor in market psychology.

At the last meeting, I noted that three major currencies were in serious trouble: the yen, sterling, and the lira. Each of these currency problems has gotten worse since the last meeting, and a fourth

currency, the Dutch guilder, has also come under speculative attack. In each case, the government and central bank concerned have been forcefully defending their currency by intervening in the exchange market, at the same time that they were using other policy instruments. In the present inflationary setting, they see quite clearly that a severe depreciation of their currencies would probably aggravate, rather than correct, their payments deficits through the inflationary consequences of such depreciation. So far, the Japanese authorities have spent \$9.2 billion in defending the yen, the British and Italians have borrowed \$2 billion and \$5 billion, respectively, in the Euro-dollar market to finance exchange market intervention, and the Dutch seem prepared to go all out in defense of the guilder.

At some point, of course, continued selling pressure on these currencies could push reserve losses and borrowings to really alarming levels, and one or another of the governments concerned might then be tempted to seek relief by letting the exchange rate slip. The market will be quick to sense and exploit through further speculation any indication of such a weakening of official resolve, just as we saw in the case of the Japanese yen when the rate was allowed to decline a few notches in October. In view of the major trading role of the countries concerned, any sharp break in their currency rates would have highly important competitive implications for their trading partners, and in due course, might lead to compensating rate adjustments elsewhere.

In this uncertain picture, what happens to the German mark will be crucial, and I must confess to some disappointment that, as Mr. Daane indicated earlier, the German position with respect to defense of the mark seems to be shifting. If they were really intent on holding the rate of 2.67 to the dollar, that could have a stabilizing effect on the market, but if they progressively back away from that rate, that could, at some point, lead to an assumption that the mark will go down another 2, 3, or 4 per cent and provoke sympathetic reactions in

markets for other currencies. For sterling, the lira, or the yen, the fall could be as much as 10 per cent. Our inability to determine at what point the Germans will firmly defend the mark precludes our joining with them in buying marks to hold the rate steady. If we did so, we could be in a position of buying \$25 million worth of marks one day and then finding the next day that the rate had gone down another one per cent. Against this background, we continue to take a cautious view about stockpiling any European currencies-- even at present rates, which in general are close to or even slightly below their central rates. However, we feel that we should intervene fairly promptly and forcefully should the dollar be subjected to a sudden burst of speculative selling.

In response to a question by Chairman Burns, Mr. Coombs said he had not made any representations to the German authorities with respect to holding the rate for the mark at any particular level. He had been assuming that they would hold pretty firmly around the central rate of 2.67 to the dollar, and later he had been given indications that they might wait until the rate went to 2.70, which wasn't much below the central rate. Although he had been disturbed by Mr. Klasen's remarks at the recent meeting in Basle, he had not yet had an opportunity to discuss the matter with the Germans. At the Basle meeting, however, he had made the point that if the Germans allowed the mark to fall significantly, the consequences could be serious for the yen, the lira, and sterling. That view was supported by the Japanese representative, who remarked that his government was in the process of

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deciding what course to follow with respect to the exchange rate for the yen and that German policy would be an important consideration.

Mr. Daane remarked that in Basle he had made fairly strong representations that at some point or points, it might be desirable to have some outflow of dollars from official holdings, especially in view of the repeated comments at earlier Basle meetings about the problem of the overhang of dollars.

Mr. Mitchell observed that Mr. Klasen had said two or three times that because of the uncertainties with respect to the oil situation and the need to buy oil with dollars, he would not use dollars to defend the exchange rate for the mark. He had also said, however, that he would defend the rate for the mark a little bit here and a little bit there, and at some point he would defend the rate strongly--to which Mr. Coombs had responded that they might wait too long. But he (Mr. Mitchell) was inclined to discount the remarks about intervention made at that meeting because of the environment in which they were made.

Chairman Burns commented that the subject of intervention was discussed thoroughly at the meeting in France. He had gotten the impression that while the Germans might hesitate, being deeply concerned about the oil situation, they would defend their currency. He would be surprised if they did not.

Mr. Coombs remarked that he too would be surprised if they did not.

Mr. Hayes asked whether recent events had thrown any doubt on the longer-range viability of the central rates established last February and whether it now appeared that the second devaluation of the dollar had gone too far.

In response, Mr. Coombs observed that participants in the foreign exchange markets felt that the dollar definitely was undervalued even though other major currencies had returned to about the central rates established last February.

Mr. Bryant remarked that the Board's staff was quite unsure whether those central rates were now appropriate; arguments could be advanced on either side of the question.

Mr. Daane commented that the general view among the participants in the Basle meeting was that they could not be sure what the right pattern of rates now might be.

Mr. MacLaury said the discussion pointed once again to the dilemma posed by a system of fixed rates. While the February change in rates might have resulted in the mark being appreciated too much in relation to the dollar, allowing it to float back down to a level that might appear appropriate was likely, as Mr. Coombs had remarked, to generate instability in markets for

other currencies. There never seemed to be a good time to allow the rate for a currency to move because such a move always had implications for other currencies.

Mr. Coombs remarked that the dilemma could be resolved by thinking in terms of the effect that intervention to defend the rate would have on the dollar overhang.

Chairman Burns observed that in view of the enormous reserves held by Germany, the current rate for the mark could be regarded as a way station. It was not necessarily a rate to be held for a very long time.

Mr. Holland commented that the strengthening of the dollar from an undervalued position afforded an ideal opportunity to reduce the dollar overhang. To allow exchange rates to move back to equilibrium without taking advantage of that opportunity would be to forego a chance to improve prospects for international monetary reform over the longer run.

Chairman Burns remarked that not many months ago when the United States was flooding the world with dollars and was exporting inflation, the dollar overhang was a serious problem. Reserves in some countries had been growing so rapidly that even central bankers became uncomfortable. However, now that the United States could no longer be charged with creating a flood of

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international liquidity or with exporting inflation, concern about the dollar overhang issue had vanished. The natural desire of central bankers to maintain large reserves had been reinforced by the oil crisis; they had come to like having the reserves, and any sizable losses made them uncomfortable. As a result, the United States was no longer the target for criticism that it had been; nor was the dollar overhang viewed any longer as a problem. However, the shift in attitude about reserves did not augur well for longer-run international monetary stability.

By unanimous vote, the System open market transactions in foreign currencies during the period November 20 through December 17, 1973, were approved, ratified, and confirmed.

Mr. Coombs then said he would recommend renewal of three swap drawings on the National Bank of Belgium, totaling \$86.8 million, that would mature for the ninth time on January 18 and 25 and February 1. Since the Belgian swap line had been in continuous use for more than a year, renewal of the drawings required specific authorization by the Committee under the terms of paragraph 1D of the foreign currency authorization.

Mr. Coombs noted that at the request of the Treasury the System was still refraining from market purchases of both Belgian and Swiss francs. In the case of the Belgian franc debt, the Treasury was now focusing on the de facto Belgian revaluation

of 2-3/4 per cent at the time of the Smithsonian meeting in December 1971. The swap agreement provided full protection against a formal revaluation of the Belgian franc. However, the action taken by the Belgians at the Smithsonian meeting was not a formal parity adjustment but rather was part of a joint Common Market move to so-called central rates. In early 1972 when the System had pressed the Belgian National Bank to honor the revaluation guarantee, they had replied, first, that they were dependent on their Treasury for financing the revaluation guarantee; second, that their Treasury took the legal position that a move to a central rate did not constitute a formal revaluation; and third, that the Common Market group seemed unlikely to move from central rates to formal parities for the foreseeable future. Against the background of that impasse, the Treasury had urged market purchases of Belgian francs to pay down the debt.

Mr. Coombs said that at the Treasury's request he raised with the Belgians once again, at the recent BIS meeting, the question of whether they could now honor the revaluation guarantee. They replied in the same manner that they had in early 1972, but they did agree to take the matter up with the Common Market governors, who were meeting on the day after the BIS meeting. The governors, in turn, referred the issue to the Finance

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Ministers of the Common Market, with a recommendation for favorable action. However, the Belgians gave him the impression that the recommendation was perfunctory and that they had little hope or expectation that the Finance Ministers would approve it. From the standpoint of the Belgian Treasury, there was a legal question concerning the distinction between a formal revaluation and a joint Common Market move to central rates, and the distinction had implications for prices and for the payment of subsidies under the Common Market's agricultural policy. Therefore, he doubted that the issue would be settled soon. Meanwhile, interest charges were accumulating at a rate of \$1.5 million per month. Nevertheless, he proposed to delay making any purchases in the market at least until after the year-end because the Belgian franc was on a weakening trend. The Swiss franc was also likely to be cheaper after the end of the year when the period of window dressing was over. Continuing the debts beyond that time probably would incur more cost in terms of interest payments than could possibly be recovered through any special arrangements that might be negotiated with the two countries after an extended period.

Mr. Daane commented that no direct conversations had yet been held between the U.S. and Belgian Treasuries and that he

was not quite so pessimistic as Mr. Coombs about the prospects of reaching an agreement.

Chairman Burns suggested that he and Messrs. Daane and Coombs meet with Under Secretary Volcker at an early date to work out a plan for attempting to resolve the issue.

Mr. Brimmer, noting Mr. Coombs' statement that issues of Common Market policy were involved in any decision made by the Belgian Treasury, asked whether the System's swap network in fact had been converted from an arrangement with individual central banks to one with the Common Market as a group.

Mr. Coombs replied that he thought not, that the only issue involved was the revaluation guarantee. The suspension of dollar convertibility in August 1971 and the Common Market's move to central rates and then to a joint float had made the original guarantee a dead letter, and an effort was being made to deal with the drawings covered by the old guarantee. Now, of course, there was an agreement to share profits and losses on a 50-50 basis, and there was no issue affecting current drawings on the swap network.

By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, maturing in the period January 18 through February 1, 1974, was authorized.

Mr. Coombs then noted that at the last meeting the Committee had approved renewal of all the swap lines for another year, and all but three of the swap partners had since agreed to renewal for that term. However, France, the Netherlands, and Belgium preferred to renew their lines for only 3 months. They seemed to feel that events were moving swiftly and that international flows of funds and conditions in the exchange markets might be on the verge of major changes. Consequently, they would like to reconsider the provisions of the swap arrangements after 3 months. He did not think any harm would be done and, therefore, recommended approval of renewal of those three lines for a period of 3 months. On a number of occasions in the past, some swap lines had been renewed for only 3 or 6 months while others had been renewed for a full year.

In response to a question by Mr. Kimbrel, Mr. Coombs remarked that the three countries probably were acting in unison. The three, along with Germany, had a more direct interest in the matter because their currencies had been selected as the ones in which the System might intervene.

By unanimous vote, renewal of the swap arrangements with the National Bank of Belgium, the Bank of France, and the Netherlands Bank for periods of less than one year, if desired by those Banks, was approved.

Chairman Burns called for a staff report on balance of payments developments for the United States and other major countries and on economic activity abroad, and Mr. Bryant made the following statement:

Abroad, as well as in this country, there is much confusion about the likely extent and duration of the reductions in petroleum supply, about their probable effects, and about the appropriate policy responses. The general dimensions of the problem, however, are beginning to clarify.

A first commanding fact, now well established, is the cutback in production of petroleum. Actual production figures show that the output of petroleum in Arab countries had already in November been cut by 5 million barrels a day, or 25 per cent, from the peak September level. There was apparently no further cut in December. But a further 5 per cent cut is scheduled for January, and that would bring the cut since September to 6 million barrels a day. If, instead, Arab output had continued to increase at the previous rate, it would have increased by some 1-1/2 million barrels a day between September and January. There is only marginal scope for increasing petroleum production from non-Arab sources. So the January shortfall of actual world output below what might have been expected will be roughly 7-1/2 million barrels a day.

A figure of about 7 to 8 million barrels a day is now rather widely accepted as the likely free-world shortage for the first quarter of 1974. And most governments are now assuming--or at least planning for the possibility of--a continued shortage of this sort through the second quarter as well. This would represent a shortage of about 15 per cent of total free-world petroleum supplies, and a shortage of about 9 per cent of total free-world energy supplies. These are very substantial numbers. They are bound to generate considerable worldwide economic dislocations.

A second commanding fact is that the average price of imported crude oil--from non-Arab as well as Arab

countries--has roughly doubled over the past six months, from \$3 to some \$6 a barrel. The price may well rise further; marginal amounts have recently been auctioned by Iran and Nigeria at prices as high as \$17.

For the United States, the first-quarter shortage of petroleum is now officially reckoned at 3.3 million barrels a day, or 17 per cent. For Europe and Japan, the percentage shortfall will be similar--say, 15 to 20 per cent--but it will represent a substantially greater shortage of total energy supplies, and particularly of industrial energy, since those countries depend much more heavily on petroleum than we do and have less scope for cutting automobile transport and space heating. Estimates vary greatly for individual countries. Japan expects to be particularly hard hit, with a petroleum shortage of 25 per cent. Germany and the Netherlands, too, seem likely to be hit hard, but there the possibility of using more coal or natural gas will afford some relief. Britain and France are examples of countries that foresee somewhat smaller cuts.

How severe an impact may these energy shortfalls have on the growth of real GNP?

For the United States, as Mr. Gramley will be explaining in a few minutes, the projected rate of growth in real GNP during the first half of 1974 has been revised downward by 3-3/4 percentage points from what we had in the November chart show. At least this large a downward revision seems required for Europe and Japan, and even larger effects are certainly possible. Official Japanese planners foresee the worst setback to production since World War II, with the real GNP growth rate cut by around 7 percentage points to zero or less. The general view of those making projections for Western Europe seems to be that the growth rate in Western Europe will fall to around zero in the first half of 1974, compared with the 4 per cent rate of increase earlier anticipated. All in all, it seems increasingly likely that we are on the verge of the first general world-wide recession since 1958.

If things do develop along these lines, however, this will be a very special kind of recession, and it

is not at all clear whether orthodox anti-recession policies will be appropriate. The question in Europe and Japan, as in the United States, is how to weigh the inflationary effects of petroleum price increases and of supply-induced shortages of other goods against the secondary deflationary effects that will result indirectly from shocks to confidence and general uncertainty, and how to cope with both of these. Thus in Europe and Japan, policy makers now face much the same unpleasant tasks and dilemmas that we face in this country. In addition, several large countries face serious balance of payments problems--from which we, for a change, seem to be fairly free. Our present view is that the U.S. balance of payments may not be greatly affected one way or another by the petroleum shortage, since export cuts as a result of lower demands abroad are likely to be offset, or more than offset, by a reduction in imports and some increase in net capital inflows.

The general view of foreign officials in mid-November at the meeting of the Economic Policy Committee of the OECD was that inflationary forces still predominated in Europe and Japan, and that fuel shortages would add, on balance, to these inflationary forces by cutting supply more sharply than demand. Hence it was felt that additional anti-inflationary actions might be needed.

This is still the prevailing view in most countries. France announced a new set of credit and fiscal restraints in late November. The British yesterday announced cuts in public spending, an increase in taxes on large incomes, hire-purchase controls, and restraints on bank credit expansion. Japan is reported to be considering a further monetary tightening.

In Germany, however, where monetary and fiscal policy have been strongly anti-inflationary, the case for restraint is now being reconsidered, for two reasons. First, it now appears that the economic boom was leveling off somewhat more rapidly in October and November than was earlier supposed. Secondly, it is thought that shocks to confidence and general uncertainty as a result of the petroleum shortage may lead to some reconsideration of investment plans, some further weakening of

consumer spending, and perhaps an erosion of export orders. The German government has begun to move cautiously toward a relaxation of fiscal restraint, and seems to be pressing the Bundesbank to move in the same direction.

It may be that in other countries, too, the possibility of slackening demand will need to be given greater weight as the winter goes on.

In this rapidly changing situation, where each country is separately assessing the situation and fending for itself as best it can, there are serious dangers of cumulative error, and particularly of divisive actions that could undermine international cooperation. The danger is clearest in connection with an intensified nationalistic scramble for oil. But it exists also in connection with general monetary and fiscal policies. As countries separately assess their own prospects, and those of their trading partners, all could end up by being too restrictive--or too easy--with the collective errors in either case generating enhanced difficulties for the world economy as a whole. It will be very difficult, too, to judge the appropriateness of particular exchange rates, and countries could turn out to be working at cross purposes in this area. Some countries may be tempted to resort to mutually damaging export or import controls.

In this environment, it may be necessary for the United States to take the lead in promoting a cooperative, multilateral approach--as Mr. Kissinger has already tried to do with energy, and as our earlier discussion this morning suggests might become urgent with respect to official intervention in exchange markets. And it will be especially important that we assess our own economic situation correctly and take promptly any policy actions that are judged appropriate.

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

Mr. Partee made the following statement:

The economy is now in transition between the course it previously appeared to be charting and one dominated by the shortage of oil. The incoming economic data, by and large, have held up reasonably well, though they tend to confirm the slowing in growth that we had anticipated. But the daily news is full of reports of materials scarcities, fuel shortages, current and planned layoffs, and curtailments in buying. And responding to fears as to the implications of the energy crisis on sales and business profits, the stock market has been notably weak.

Thus far, the only clear evidence we have of a fuel-related weakening in sales is in automobiles and gasoline. New car sales have dropped off only moderately into early December, but this has been at the cost of a drawing down in compact car inventories to minimal levels; stocks of intermediate- and larger-size models have built up further, to a 60-day supply. Sales of new houses by merchant builders declined further in October, when they were more than one-third below the year earlier level. This decline probably reflected mainly the mortgage situation, but anxiety about heating oil and gasoline supplies may also have been a factor; certainly that has been emphasized in reports of very poor sales traffic in the outlying subdivisions since then. The much smaller rise in the industrial production index over recent months, on the other hand, seems attributable to shortages of other materials and component parts more than to shortages of fuel. The slowing in growth was especially notable in industrial materials and in business equipment, where we believe that customer demands have remained exceptionally strong.

The staff has made a major effort over the past month to revise our GNP projection in light of the continued embargo on shipments of Mid-East oil to the United States. You have already seen the results of that new projection in the green book,^{1/} and I have asked Mr. Gramley to amplify on that projection and on the reasoning underlying it, as a part of our presentation today.

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

Mr. Gramley made the following statement:

Since the last meeting of the Committee, the staff has been grappling with the oil shortage and its implications for economic activity. The results of our efforts are reflected in the significantly weaker GNP projection for 1974 presented in the green book. The uncertainties in this area are, of course, enormous. Let me outline briefly our assessment of the problem, beginning with two key assumptions.

First, we believe a figure of some 3 to 3.5 million barrels a day is a reasonable estimate of the supply shortfall, in line with the Administration's thinking. For purposes of our projection, we postulate a continuance of the Arab embargo throughout all of next year for oil to the United States, but a resumption of oil shipments to Europe and Japan by about midyear.

Second, we assume the Administration will largely succeed in its attempt to ensure adequate supplies of petroleum for production inputs and process heating by industry. Further conservation measures will need to be taken to accomplish this objective--including additional steps to curtail gasoline consumption in passenger cars by roughly 30 per cent in all. The reduction in gasoline consumption by consumers is expected to be accomplished mainly by some form of non-price rationing, but the retail price of gasoline is also projected to rise about 30 per cent over the next four quarters.

This second assumption implies that any direct supply effects on GNP next year would be small, and that bottleneck problems would not be of sufficient consequence to curb aggregate output. Outside of petroleum refining, production would be cut back by around 10 to 12 per cent because of the shortage of crude, and this would reduce real GNP by a little less than one-half of 1 per cent. We have made only a minimal allowance--around one-quarter to one-half of 1 per cent--for other direct supply effects. If this second assumption proves wrong, output and employment would likely decline more--possibly much more--than we have projected.

The biggest part of the curtailment of real GNP we foresee comes from reductions in demand for goods and

services that are complements to the use of gasoline for travel. There is a long list of items for which demands are likely to be adversely affected beginning with autos (for which the problem is aggravated by a limited capacity to produce small cars), but also including tires and auto parts, auto repair services, mobile homes (which generally are located in outlying areas), campers, boats and other recreational vehicles, food away from home, and motel and hotel services. In the area of investment goods, we are likely to see adverse effects on homebuilding in the more remote suburban areas and on construction of vacation homes, on jet aircraft purchases by commercial airlines, and on construction of motels and shopping centers, with only minor offsets in investment in mining and railroads.

We have made estimates--very crude ones--of how much decline in expenditures might take place in each of these areas. The most important of these estimates is for autos, where we have projected unit sales of domestic-type cars to decline to around a 6.5 million annual rate, a cutback which is worth around \$7 billion in terms of current dollar GNP. Other consumer expenditures related to travel might fall as much as \$8 to \$10 billion, but we think that consumers might substitute other purchases for around three-fourths of this amount. For gross private domestic investment, we have reduced estimated outlays due to the oil shortage on net by around \$4 billion, mainly reflecting lower residential construction.

We ran these estimates through our econometric model, and also through our judgmental forecasting procedures, to assess the secondary effects on income, employment, and expenditures. The outcome, as shown in the new GNP projection in the green book, is disquieting. Growth in real GNP over the four quarters of 1974 averages 2 percentage points less than our previous estimate, and there are declines projected in the first two quarters of next year. The unemployment rate is projected to increase to 6 per cent by year end. The rate of increase in the fixed-weight price index for private GNP, meanwhile, is raised almost three-fourths of a percentage point, and this index is projected to be rising at a 5.5 per cent annual rate in the last half of next year.

The configuration in output and employment we foresee for next year does not, however, have the cumulative cyclical characteristics of a typical business recession. We are impressed by the underlying strength of business demands for capital goods, which should help to ward off the threat of a cumulative decline. And, as time goes on, adjustments to the oil shortage will likely reduce the severity of the impact on economic activity. These adaptations could, we think, set the stage for a resumption of growth in real GNP--albeit at a subdued pace--in the second half of next year.

Our current projection could prove to be overly pessimistic if the oil shortage turns out to be of smaller magnitude than we have assumed, or if the process of adaptation by businesses and consumers goes on more quickly. But there is an equally likely prospect--in my judgment--that our projection understates the economic consequences of the oil crisis. In particular, if the allocation program does not assure adequate industrial supplies of oil, or if economic activity in Europe is affected more adversely than we have supposed--threatening our export markets--or if business capital expenditure plans are revised downward for expectational reasons, production and employment next year could go much lower.

In developing this new projection, we did not assume any major economic policy changes designed to cushion the economic impact of the oil shortage. As before, the narrowly defined money supply was assumed to grow at a rate of around 5 per cent next year. For fiscal policy, we assumed only a modest increase in expenditures later in 1974 reflecting the beginning of a long-range program aimed at self-sufficiency in the energy field and the increase in unemployment benefits that comes automatically with a rise in the level of unemployment. Even so, the Federal deficit as measured in the NIA accounts is projected to increase to around a \$17 billion annual rate by the fourth quarter, largely reflecting the curtailment of growth in receipts that accompanies an economic slowdown.

From this base projection, we have tried to assess the possible effects of compensatory policy actions, as Mr. Partee will now indicate.

Mr. Partee concluded the report with the following statement:

In view of the quite unsatisfactory results of our new GNP projection for 1974, it is reasonable to ask what public policy can do to cushion the weakness that we believe to be in immediate prospect. The problem is complicated by the fact that the inflation rate is now expected to be significantly higher, due mainly to higher oil prices, and that supply constraints in some areas pose the danger that a generalized bolstering of demand could add more to inflationary pressures than to real output. Nevertheless, with the growth rate in real GNP dropping to minimal levels over the next year--probably negative in the first two quarters and only mildly positive in the second two--and with the unemployment rate likely to climb to as high as 6 per cent or more, the case for some ameliorative action by the Government seems to me compelling.

Therefore, we have tried to see what the effects might be of a moderately stimulative program, involving both fiscal and monetary elements. On the fiscal side, we have assumed that Government expenditures for grants and transfer payments would be increased gradually, and would be running at an annual rate \$5 billion larger than otherwise by the fourth quarter of 1974. Some of this spending is assumed to go for a revitalization of the public employment program, which would tend directly to reduce unemployment, and some would be for programs that reduce the social costs of unemployment, including larger unemployment compensation benefits and welfare payments. As for monetary policy, we have increased the assumed rate of growth in the narrow money stock by 1 percentage point--to 6 per cent--which just about compensates for the faster increase in the price level projected now as compared with four weeks ago. Interest rates, on this assumption, would nevertheless decline appreciably--especially short-term rates--since the projected growth in nominal GNP would still be a good deal less than that expected in the chart show presentation four weeks ago.

The results of our econometric model suggest that the impact of these policy initiatives, over the course of a year, could be appreciable. As compared with our

judgmental projection, the model shows real GNP by the fourth quarter as being \$5 billion higher, and the unemployment rate, at 5.5 per cent, one-half point lower, than in the judgmental projection, the latter reflecting in part the direct effect of governmental programs in taking people off the unemployment rolls. Looking into 1975, the effects are even more significant, as residential building and plant and equipment expenditures are stimulated with a lag by lower interest rates and the greater availability of credit.

Unfortunately, these policy changes would also involve some cost. Stronger market demands and lower unemployment would further intensify inflationary pressures, and the model indicates that the GNP deflator might be around three-tenths of a percentage point higher by mid-1975 as a result of the assumed policy initiatives. But the trade-off as against unemployment is a reasonable one, I believe, when the alternative is an unemployment rate as high as 6 per cent. Stronger actions, of course, could do proportionately more to limit the rise in unemployment, but the result would be to add still more to inflationary pressures and to run the risk that demands in numerous product markets would be in excess of the constrained supply available. What is assumed in our alternative GNP projection, then, represents a minimal program, but one that we think would show meaningful results in dampening the impact of the fuel shortage and in providing added insurance against a cumulative and self-reinforcing decline.

Chairman Burns asked whether the members had any questions they would like to direct to the staff.

Mr. Kimbrel asked what assumptions about defense expenditures had been made by the staff in preparing the projections.

Mr. Partee replied that in the latest projections defense outlays were essentially the same as those presented at the November meeting, which had been raised somewhat on the expectation that inventories drawn down because of the Mid-East war

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would be replaced. It now seemed likely that the defense establishment would have to reduce its consumption of fuels, but projected expenditures for fuel would be about the same as before because of increased fuel prices.

Mr. Mitchell commented that the assumption that the oil crisis would persist throughout 1974 was an arbitrary one, and he wondered about the economic consequences of a resolution of the crisis at an early date--say, by midyear.

Chairman Burns asked what the effect might be if the crisis ended in a month.

Mr. Gramley observed that the staff assumption of a continuing crisis throughout 1974 had been made for the purpose of providing an assessment of the magnitude of the effects of a sustained shortage. However, if the Arab embargo on shipments of oil to the United States were terminated in June, the shortages' negative effects on real GNP during 1974 would be reduced. If the embargo were ended in a month, markets for automobiles and housing probably would not be nearly so weak as suggested in the projections presented today; over all, growth in real GNP in 1974 would be only a little less than suggested in the projections of a month ago, which did not take the oil shortage into account.

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Mr. Mitchell remarked that he was in search of the implications for today's policy decision of the possibility of an early end to the embargo.

In response, Mr. Partee noted that the projections made a month earlier--without allowance for the effects of an oil shortage--had suggested a low rate of growth in real GNP and a rising rate of unemployment in 1974. That prospect had been regarded as minimally satisfactory because of the strength of inflationary pressures. Announcement of an early end to the oil embargo--with the prospect of improvement in supplies of refined products some 6 weeks later--would have an immediate effect in improving expectations. In their second thoughts, however, people would recognize that the energy problem had been developing before the embargo was imposed and that oil would remain in short supply. They would realize that it would still be expensive to drive large cars and that there were risks in buying vacation and suburban homes. Business managers contemplating plant construction would still be faced with difficulties in getting hookups of utilities and allocations of propane, which they had been reporting even before the embargo was imposed. Consequently, he would not expect economic activity to reach the higher levels that had been projected a month earlier, before the oil crisis was taken into account.

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Mr. Partee added that notwithstanding a resumption of the flow of Arab oil to the United States, the price of oil would be much higher than had been contemplated earlier. In the latest projections, the higher price for oil contributed three-fourths of a percentage point to the rate of increase in the fixed-weight price index for private GNP by the fourth quarter of 1974; the price index was projected to be rising then at a rate of 5.5 per cent. The stepped-up rate of increase in prices had implications for the real stock of money and, therefore, for monetary policy.

Chairman Burns commented that very difficult questions of judgment were involved in appraising the effects of a termination of the embargo in a month or two. In his view--and it was only a guess--it would have enormous and lasting effects on attitudes, and the investment boom that was currently under way would be greatly intensified.

Mr. Coldwell asked if there was any information to indicate whether industry had been stockpiling significant amounts of fuels and raw materials.

Mr. Partee replied that data were not available in sufficient detail to indicate what might be happening to stocks of fuels. However, there were frequent reports--for example, in

the latest red book^{1/} and at the recent Conference of Chairmen-- that business had been stockpiling fuels. With respect to materials, the available data--which measured manufacturers' inventories of purchased materials rather than strictly raw materials--indicated only a moderate increase over the past year. However, the ratio of purchased materials to shipments actually had declined over the year.

Mr. Black noted that at this time a year ago the unusually large refunds of income taxes in prospect for early 1973 had generated a great deal of concern about their effect on consumption expenditures, and he asked what the staff anticipated with respect to refunds and their effects in early 1974.

Mr. Partee said the income tax refunds in early 1974 might be about 10 per cent larger than the \$22 billion of 1973. Assessing the effect of the refunds on consumption expenditures next year was complicated by two factors. First, the recurring phenomenon of large tax refunds in the first half of the year had been reflected in the seasonal adjustment factors for disposable personal income, with the result that the refunds were spread through the year; there was no longer a first-half bulge in the Commerce Department

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

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series. Seasonal adjustment factors for consumption expenditures also would be affected to a limited extent, so that a part of the spending related to the refunds would be adjusted out. Secondly, the oil crisis made it doubtful that consumers would use the refunds to purchase such luxury durable goods as automobiles and boats to the extent they had in 1973. Therefore, he expected that the refunds would have a good deal less impact on consumption expenditures in the first half of next year than they had in the first half of 1973.

Mr. Brimmer asked, first, whether the moderately stimulative policies that the staff had appraised--involving a 6 per cent rate of monetary growth--were sufficient to eliminate the recession that otherwise was projected for early 1974, and secondly, what the implications were for the level of short-term interest rates. In his view, the answers to both questions were important elements in appraising the trade-off between the improvement in the unemployment rate and the faster rate of increase in prices associated with the more expansive policies.

Mr. Partee replied that even with monetary growth at a rate of 6 per cent, rather than 5 per cent, growth in real GNP was projected to be negative in the first half of next year because of the lags with which monetary policy affected economic

activity. Taking both the faster rate of monetary growth and somewhat higher Government spending into account, real GNP in the fourth quarter of 1974 would be only about \$5 billion or six-tenths of a per cent higher than otherwise. However, the expansive effects of those policies would be greater in 1975.

With respect to interest rates, Mr. Partee noted that in the staff presentation of 4 weeks earlier, the rate for 3-month Treasury bills had been projected to average about 8-1/2 per cent in 1974. He would guess that the weaker economic situation suggested by the latest projections would reduce the bill rate to an average of about 7 per cent next year. In those circumstances, a step-up of the rate of monetary growth to 6 per cent might gradually reduce the bill rate to about 6-1/2 per cent in the latter part of the year.

Mr. Eastburn asked whether Mr. Partee or Chairman Burns could assess the probabilities that Government action would be taken to increase transfer payments and otherwise to reduce the social costs of rising unemployment in 1974.

In response, Chairman Burns observed that the Administration was developing systematic and comprehensive contingency plans for supplementary unemployment compensation, for local government spending in certain regions of high unemployment, and

for public works construction. With a longer perspective, the Administration was developing a massive project--along the lines of the war-time Manhattan Project--to deal with the energy problem.

Mr. Balles asked whether input-output tables could be of much use in appraising the effects of the energy shortage.

Mr. Gramley replied that the staff had only recently begun to analyze the specific effects of supply shortages and had not made use of the input-output tables in developing its projections. In his judgment, the tables would help in making some crude estimates, but they could not help in appraising the possibilities for substitution and the effects of changes in the geographic distribution of supply.

Mr. Morris remarked that an executive of one of the automobile manufacturers had indicated that the ability of his company to shift its product mix in favor of small cars was very limited over the next 18 months, prior to introduction of 1976 models, and that around the first of the year, the company would announce massive cuts in production of the larger cars. For the interim, the company was concentrating on improving the efficiency of its engines. In the view of that executive, termination of the Arab embargo at an early date could improve the situation, provided

that consumers were then willing to continue to buy the larger automobiles. However, he conveyed a lack of conviction that the change in consumer tastes in automobiles was only a temporary one.

Mr. Sheehan remarked that another executive of an automobile company had told him essentially the same thing.

Chairman Burns commented that still another executive in the automobile industry had described the reconversion problem to him in a different way. In the circumstances, he thought it would be useful for the staff to investigate the industry's potential to alter its product mix within the next few months.

Mr. MacLaury noted that Mr. Bryant had concluded his report by suggesting that the United States needed to exert leadership with respect to international economic developments and that it needed to follow the right domestic policies. He asked Mr. Bryant to comment further on those issues.

Mr. Bryant said the staff was in the process of appraising the appropriateness of the economic policies being followed in major foreign countries, and did not yet have an assessment they held with confidence. Nonetheless, at present he and other members of the staff were concerned that the policies being followed by some countries were too restrictive and that recessionary pressures might build up around the world. Because of this uncertain outlook for the world economy, it was especially important at this time for international as well as for domestic reasons,

that the United States pursue policies that were not too restrictive. With respect to international leadership and cooperation, he noted that the Secretary of State had already proposed an initiative concerning the energy problem. Exchange market intervention, which Mr. Coombs had discussed, was another important area for international cooperation. No useful purpose would be served by exchange rate and intervention policies which resulted in a general devaluation of the industrial countries against the oil-producing countries.

Mr. MacLaury observed that he was in general agreement with Mr. Partee's presentation on the domestic situation, but he would have expected the oil problem to cause a larger increase in the rate of rise in the GNP deflator. He asked about the assumptions the staff had made in projecting prices.

Mr. Gramley replied that the projections reflected an assumption that the rationing of scarce gasoline would be accomplished in large part by nonprice means. To perform a market clearing role, the rise in gasoline prices would have to be much more than the 30 per cent increase from the fourth quarter of 1973 to the fourth quarter of 1974 assumed for the projections. In effect, therefore, the reduction in demands for such things as recreational vehicles and suburban housing

resulted much more from demand complementarities than from the negative effects of rising prices on real income.

Mr. Partee added that the limited growth in real GNP projected for 1974 slowed the advance in productivity and stepped up the rise in unit labor costs. In the projections, much of the increase in unit labor costs was reflected in a reduction in profit margins, rather than in higher prices, but there was the further question of the size of wage advances that would be demanded at a time when prices of gasoline and of home heating oil were rising substantially. It seemed possible that the staff's assumptions with respect to wage increases might have given too much weight to the influence of the weakening in economic activity and in the demand for labor and not enough weight to the impact of sharply rising consumer prices.

Mr. Winn remarked that according to businessmen with whom he had talked, prices for a great many things other than petroleum products, especially nondurable goods, were already being raised substantially. With respect to the ramifications of a weakening in demands, he noted that a sizable decline in automobile sales and production usually led a decrease in production of steel and some other important materials. In the current

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situation, however, the steel and other materials made available by the decline in auto output would be readily absorbed because of an upsurge in demands for various kinds of capital equipment.

Mr. Partee commented that the staff had assumed that wages and prices would be decontrolled gradually and that a surge in prices would be avoided, but the projected rise in the deflator next year was substantial. With respect to the improvement in the availability of steel and other materials growing out of the reduction in demands for automobiles, there was a question of whether producers could obtain the required amounts of fuels.

Mr. Winn said it had been reported at the last meeting of the directors at the Cleveland Bank that some technological break-throughs had been made to permit electric cars to go at 90 miles an hour for a distance of 500 miles. The thought was advanced that the battery could be exchanged at a service station in much the same way as the gas tank now was refilled. However, production of such cars probably was still several years in the future.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of System

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Open Market Account covering domestic open market operations for the period November 20 through December 12, 1973, and a supplemental report covering the period December 13 through 17, 1973. Copies of both reports have been placed in the files of the Committee.

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

Concern about the energy crisis and its implications for the economy and speculation over the course of monetary policy tended to dominate financial markets over the period since the Committee last met. Interest rates fluctuated considerably over the period. Early in the period rates, particularly on Treasury bills, tended to move lower as strong market sentiment anticipated an easing in monetary policy. As the period wore on, the rally lost steam as dealer financing costs remained high. Chairman Burns' statement on December 5, indicating that monetary policy would be of limited usefulness in the energy crisis, led to a further back-up in rates. The back-up was short-lived, however, and the reduction of marginal reserve requirements on large CD's was generally viewed as a market easing action. The rally that ensued continued through yesterday as market participants have been focusing closely on open market operations, exhibiting a fervent desire to read signs of easing in our every move. In yesterday's regular Treasury bill auction average rates of 7.37 and 7.16 per cent were established for 3- and 6-month bills, down 33 and 64 basis points from the rates established just prior to the last meeting.

The Treasury, as you know, raised \$3 billion in cash through the sale of tax-anticipation bills in an

auction that attracted good market interest. The expiration on November 30 of the temporary debt ceiling of \$465 billion necessitated some fast footwork by the Treasury, including the delivery of the tax bills to the Exchange Stabilization Fund on November 30 before the debt ceiling dropped to its permanent level of \$400 billion. The ESF then delivered the bills to the auction winners on the normal delivery day--December 3--and all went smoothly. The temporary postponement of the regular Treasury bill auction on December 3 caused some confusion, but with passage on that day of a clean bill extending the \$465 billion debt ceiling the confusion was short-lived.

System open market operations over the period aimed at a reserve supply that would meet the Committee's 2-month target ranges for M_1 and M_2 . Strong growth in the two measures--despite another shortfall in RPD's--kept the funds rate in the upper end of the 9 to 10-1/2 per cent range adopted by the Committee. Had the Committee not instructed the Desk on November 30 to stay around 10-1/4 per cent, the full extent of the funds rate range would have been used. Reserve projections were particularly uncertain over the period, and there was some tendency for the funds rate to fall off toward the end of several of the statement weeks in the period. All in all, the rate averaged about 10-1/8 per cent, although there were substantial day-to-day fluctuations.

Over the entire period there was a substantial volume of orders to buy and sell securities from foreign accounts, part of which fell in rather well with the System's need to supply or withdraw reserves. Gross bill transactions with foreign central banks amounted to nearly \$800 million, with System purchases outweighing sales by only \$38 million. The System also acquired \$200-odd million of coupon and agency securities from a foreign official account which is continuing to move to a more liquid position because of continuing exchange losses.

The current statement week has been something of a problem. While all the reserve projections before the weekend indicated a substantial reserve need, this was not reflected in the money market where the funds rate tended towards the easy side. It was quite apparent

that many large banks, convinced that the System was easing, were postponing covering their reserve needs in the expectation that they would be bailed out by System operations. Given the sensitivity of market expectations, we were quite reluctant to make a substantial overt entry into the market to supply reserves while the Federal funds rate was at the 10 per cent level. We were able to supply some reserves by purchases from foreign accounts, but a large reserve deficit did accumulate over the weekend. Yesterday, the reserve shortage showed through in the money market and the Desk made a large injection of reserves, including outright purchases of about \$670 million Treasury bills and \$1.2 billion of 3-day RP's. Also, we learned this morning that reserves were about \$700 million higher than expected, probably as a result of float. There may be more to do this statement week, but current projections--which are subject to rapid change--indicate little need for much Desk activity over the balance of the year.

Mr. Holmes added that the Government securities market would be virtually closed on Monday, December 24. However, in light of the anticipated churning that was customary around year-end, the Account Management had asked that the market remain open on Monday, December 31.

Mr. Holland noted that one factor contributing to the rise in M_1 in November had been a build-up of foreign central bank balances at the Federal Reserve. He asked about the current status of those balances.

Mr. Holmes replied that the balances had now been reduced to normal levels.

In response to a question by Mr. Daane, Mr. Axilrod said that the temporary increase in official account balances at the Federal Reserve had added about one percentage point to the November growth rate in M_1 . There also had been some temporary build-up in foreign official balances at commercial banks.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 20 through December 17, 1973 were approved, ratified, and confirmed.

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

As compared with specifications presented by the staff at the last Committee meeting, the alternatives presented for Committee consideration today^{1/} generally indicate lower interest rates for any desired rate of growth in monetary aggregates. This reflects the substantial downward revision in staff projections of growth in nominal GNP to allow for the impact of the oil shortage.

Recently, market expectations have led to some decline in short-term market rates following the Board's announcement of a reduction in the marginal reserve requirements on large CD's and related bank liabilities. In particular, U.S. Government securities dealers have been building up positions in both short- and long-term securities.

Thus, market rates appear poised either to back up if the money market remains tight, or to decline further, perhaps considerably further, if the money

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

market clearly begins to ease. Monetary policy always has to contend with expectations, and I do not see at this time that there is anything to be gained by permitting policy to be significantly influenced by market attitudes toward interest rates.

If the Committee were to permit the money market to ease, for example, any ensuing decline in market interest rates could, in practical terms, only be of some help to the mortgage market by ensuring continued good inflows to thrift institutions in early 1974, when fairly large amounts of certificates will be maturing. With fears of recession fairly widespread, I would doubt that declining interest rates in the near-term would significantly worsen inflationary expectations, since most of the public is already convinced that the energy shortage itself will do that.

In considering its policy toward money market rates, the Committee may, however, wish to take account of possible shifts in the public's attitude toward liquidity. There may have been some shift in demand for liquidity, including cash, in the fourth quarter, reflecting economic and financial uncertainties here and abroad. The alternative B path offsets that fairly promptly by targeting only a 4 per cent growth rate for M_1 in the first quarter. The Committee may wish to consider whether it would be desirable to tolerate a somewhat higher growth rate on the grounds that the increased demands for cash of the fourth quarter do not reflect cash that is likely to be spent over the next few months.

In part, the money provided in the fourth quarter may represent funds that will later be invested in other financial assets, and in part, it may reflect at least the first signs of a longer-term shift in cash demands. The larger increase in prices for the first half of 1974 now forecast would argue that there will be an increase in the public's demand for cash merely in an effort to keep the real value of cash balances from falling. With the private fixed-weight GNP price index rising at about a 6-1/2 per cent annual rate from the fourth quarter of 1973 to the second quarter of 1974, money growth in real terms would be declining under alternative B, and it also would decline slightly even under alternative A.

If there is any conflict between the Committee's objectives for the monetary aggregates and interest rates, these various considerations would tend to argue for resolving doubts in favor of permitting somewhat greater growth in the aggregates, at least over the near term, while the economy is adapting to the energy shortage.

Mr. Balles noted that the three alternatives for the operational paragraph of the directive distributed late yesterday called, respectively, for "more," "somewhat more," and "slightly less" growth in the monetary aggregates over the months ahead "than is currently estimated for the second half of 1973." In the notes attached to the drafts, the estimated second-half growth rates for M_1 , M_2 , and the credit proxy were indicated to be 3.5, 7.7, and 5.8 per cent, respectively. Those figures appeared to be based on comparisons of estimated levels for December with the levels recorded for June. As he had indicated at other recent meetings, he preferred to consider such growth rates in terms of quarterly-average levels, and he wondered whether figures for the estimated growth rates over the second half of the year had been calculated on that basis.

Mr. Axilrod replied that the figures in question would be made available later in the meeting.

Mr. Morris noted that the blue book^{1/} contained a chart captioned "Money supply and longer-run target path" in which the

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

preliminary revised series for M_1 from April 1973 through the level estimated for December was plotted in the form of a solid line. The chart also included an upward-sloping dashed line labeled "5 per cent growth" that started with the level of M_1 in September 1973 and extended through June 1974. He asked Mr. Axilrod to explain the significance of the dashed line.

In reply, Mr. Axilrod observed that the GNP projections presented in the chart show at the November meeting, as well as those given in the current green book and discussed by Mr. Gramley today, were based on an assumption of growth in M_1 at a 5 per cent annual rate, starting from the September 1973 level of the preliminary revised money supply series. Moreover, the specifications adopted by the Committee at the November meeting included a target growth rate for M_1 of 5 per cent over the fourth and first quarters combined--that is, from September 1973 through March 1974. The dashed line labeled "5 per cent growth" in the blue book chart was identical to one shown in a chart in the previous blue book, except that it had been extended from the previous terminal date of March 1974 through June--in accordance with the expectation that the Committee would formulate its longer-run targets today in terms of growth rates over the first and second quarters of 1974. The level of the dashed line shown for

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June 1974 was consistent with the M_1 growth rate for the first half of 1974 shown under alternative B in the current blue book. That growth rate was below 5 per cent--specifically, it was 4-1/2 per cent--because current estimates indicated that in December 1973 the level of M_1 would be about \$1 billion above the 5 per cent growth path measured from September.

Mr. Hayes asked whether the September 1973 level of the preliminary revised money supply series was not substantially above that of the currently published unrevised series.

Mr. Axilrod replied that the September level of M_1 would indeed be revised upward, by about \$2-1/2 billion according to the latest estimates. Such an upward revision had, of course, been allowed for in the GNP projections presented at the November meeting.

Mr. Mitchell asked whether it would not be better to use a period longer than a single month as a base for measuring longer-run growth paths. September 1973 in particular appeared to be an artificial starting point, since the series dipped temporarily in that month.

In reply, Mr. Partee said he agreed that it would be undesirable to use an unusual month as the base. He might note, however, that the September level of M_1 was not as unusual as

the dip shown in the chart might suggest. As the Committee would recall, during the second and third quarters of 1973 the money supply had first overshot and then undershot the Committee's earlier target paths based on the unrevised series, and in September it was quite close to the path level.

Chairman Burns noted that, while charts such as the one under discussion had been included in the blue books for the past 6 months or so, the Committee had never agreed to adopt such charts as a guide to policy; it had explicitly formulated its longer-run targets for the aggregates in terms of growth rates over 6-month periods. Any member was, of course, free to interpret such charts as he chose, but they would not constitute policy guides until the Committee deliberately decided that they should serve that function.

Mr. Bucher referred to Mr. Axilrod's suggestion, at the conclusion of his earlier statement, that in the event of conflicts between objectives for the aggregates and interest rates, the Committee might want to resolve doubts in favor of permitting somewhat greater growth in the aggregates over the near term. He asked whether that suggestion was reflected in the specifications under any of the alternatives shown in the blue book.

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In reply, Mr. Axilrod said the blue book specifications did not include any allowance for the possibility that the public might decide to increase its cash holdings temporarily because of uncertainty, say, about the course the Government would follow in dealing with the energy crisis.

In response to a further question by Mr. Bucher, Mr. Axilrod said that, if the Committee decided to make such allowance, it might add at least one percentage point to the upper limits of the ranges shown in the blue book for growth rates in the aggregates over the December-January period.

Chairman Burns then noted that the Committee would be recessing for luncheon shortly. Following the recess, the members might express their views on the economic outlook and on the appropriate course for monetary policy at this juncture, including any views they might have on policy instruments that lay within the province of the Board of Governors rather than the Committee. All of the members, including himself, had been thinking hard about the task of monetary policy in the present difficult and unusual period, and he might indicate the nature of his own thinking in the brief period remaining before luncheon.

Whether or not they accepted the staff's prognosis, the Chairman continued, most of the members would probably

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agree that the economic outlook for the new year was less bright than it had been 2 months ago, and that a recession in 1974 now had to be considered a distinct possibility--perhaps even a probability. In a classical business recession, the task of monetary policy had in recent decades been quite clear; that task was to carry out a major easing of credit conditions in order to lay the foundation, to the extent that was possible through monetary policy, for a business recovery. However, the recession that might develop next year would differ from a classical recession in several major respects. First, such a recession would occur at a time when the price level would probably be rising sharply, rather than remaining stable or declining. Secondly, such a recession would occur at a time when the nation's capacity to produce would probably be declining, or at best rising at an abnormally low rate. Third, it would occur at a time when many types of economic activity in many localities would probably be booming.

In view of those three peculiarities of any 1974 business recession, Chairman Burns observed, the task of monetary policy could not be the same as in a classical recession. The continuance of sharp inflation clearly required caution and some restraint in carrying out a policy of monetary easing. The need for caution and restraint also was indicated by the energy shortage; at such

a time monetary policy might indeed be able to stimulate--or restimulate--aggregate demand, but it was doubtful whether it could do much to overcome the short-run limitation on the nation's capacity to produce. Finally, a need for caution in carrying out a policy of monetary easing was indicated by the sharp divergence that was likely to occur in the fortunes of individual communities across the nation. That type of recession, in his judgment, could be handled much better by a policy of localized governmental spending than by a policy of over-all monetary easing.

Accordingly, the Chairman remarked, it was highly important for the Committee to bear in mind the need for caution. Nevertheless, he would still argue that monetary policy could be a marginally constructive force in an energy-induced recession. A decline in output because of restrictions on the capacity to produce would surely lead, after some time had elapsed, to a reduction in aggregate demand. True, monetary and fiscal policy might be unable at such a time to do much to expand output by restimulating aggregate demand. Monetary and fiscal policy could, however, seek to limit the decline in aggregate demand, so that it did not fall significantly below the nation's capacity to produce. To put the same thought in another way, at a time of energy shortage, monetary policy--instead of aiming to bring a

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recession to an end--should merely aim to keep the recession from becoming deeper than the restricted capacity to produce in itself required.

On balance, the Chairman concluded, he believed that some easing of monetary policy was indicated today, but that it should take the form of a modest and cautious step. He was aware of the possibility that the oil embargo might not last more than another few weeks. On the other hand, the embargo might last another year. He would leave for the members to evaluate as they saw fit the suggestion that they consider some slight easing as the next policy move.

Thereupon the meeting recessed for luncheon. It reconvened at 2:30 p.m., with the same attendance as at the morning session.

Mr. Mayo observed that he agreed with the views expressed by the Chairman before the luncheon recess. In particular, he concurred in the points that monetary policy could play only a marginal role in an energy-induced recession, but that it should nevertheless not remain rigid because of the expected continuation of sharp inflation. He commended the Board of Governors for the recent reduction in marginal reserve requirements on large-denomination CD's; that was a step in the right direction, and it

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would prove helpful to the Committee in implementing the kind of change in open market policy which he favored--namely, a slight shift toward ease. He would not want to go further than that, in view of the declines in short-term market rates that had already occurred and the further declines in rates which he, along with the authors of the blue book, would expect to be associated with some reduction in the Federal funds rate.

On the whole, Mr. Mayo continued, he thought the specifications of alternative B were consistent with the policy course he favored. He would, however, widen the ranges for growth rates in the aggregates for the December-January period from 2 to 3 percentage points, primarily because of the great uncertainty with regard to linkages in the present unusual period. Specifically, in place of the ranges of 8-1/4 to 10-1/4 per cent for RPD's, 3 to 5 per cent for M_1 , and 5 to 7 per cent for M_2 , he would favor ranges of 8 to 11, 2-1/2 to 5-1/2, and 4-1/2 to 7-1/2 per cent, respectively, for those aggregates. A corresponding widening of the range for the Federal funds rate did not seem to be required, and he considered the range shown under B in the blue book--9 to 10-1/4 per cent--to be satisfactory. He would not be disturbed by a quarter-point reduction in the lower limit, to 8-3/4 per cent, but he would not want to go further than that.

Mr. Hayes observed that it was especially difficult to assess whether fears of shortages and supply-induced cutbacks in real output would result in a significant downward shift in business and consumer sentiment and spending plans. Apart from consumer demand for automobiles, there seemed to be little indication of such a shift to date. The latest red book, for example, did not indicate a significant change in business capital spending plans.

Mr. Hayes said his views on the impact of the energy shortage on real output and unemployment were reasonably close to those set forth by the staff this morning. However, he was more pessimistic on the price outlook. Even with some formal or informal system of gasoline rationing, it was difficult to see how an energy price "explosion" could be avoided over the coming months. Indeed, the latest wholesale price figures indicated that an explosive rise in energy prices was already under way.

As was true when the Committee met a month ago, Mr. Hayes continued, a cautious approach to policy formulation seemed highly appropriate today. While there was not much that monetary policy could do to relieve the economic problems arising from the oil shortage, an unwise policy could exacerbate the problems. The rate of inflation, actual and prospective, had been sharply increased, and inflation remained the number one economic problem.

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While a cumulative downswing in aggregate demand was one possible result of the fuel situation, there was as yet no evidence that it was taking place.

Thus, Mr. Hayes remarked, he continued to believe that the present posture of restraint should be maintained, although the System should, of course, be alert to any clear sign of real weakness in the economy and should be prepared to move vigorously toward ease if such weakness became evident.

Continuing, Mr. Hayes noted that credit demands had been swinging back to the banks from the commercial paper market in recent weeks. Also, demands on the capital market had tended to strengthen. Incidentally, to the extent that interest rates included some reflection of current and prospective rates of inflation, any given nominal interest rate today embodied a lower real rate than it would have a few months ago. The behavior of the aggregates this year gave some cause for concern, with M_1 likely to show nearly 6-1/2 per cent growth on a revised basis for the last three quarters of the year, following the Committee's decision in March to set a 5-1/4 per cent longer-run target. He would deemphasize the shorter-run growth of the aggregates as a criterion for policy and would aim at a longer-run M_1 target of not more than 5 per cent. The rapid increase in income velocity

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of M_1 over the last four quarters pointed up the risks in looking only at the growth rates of the aggregates while making no allowance for velocity changes. A reasonably steady Federal funds rate close to the recent level would seem to be the best current guide for the Manager, with a funds range of perhaps 9-1/2 to 10-1/2 per cent.

Mr. Hayes suggested the addition of a sentence in the first paragraph of the draft directive to provide a little better balance to the discussion of the energy crisis, pointing out that the crisis would undoubtedly bring sharper price rises. He liked the B specifications except that, as he had indicated, he would change the range for the funds rate to 9-1/2 to 10-1/2 per cent, and he would revert to the original draft language of alternative B as set forth in the blue book, which called for "somewhat slower growth in monetary aggregates over the months ahead than has occurred so far this year." He could see no reason to change the discount rate. A good case could be made for lowering margin requirements in the light of the stock market's acute weakness, but some delay might be desirable to avoid adding to whatever impression of general credit easing might have been created by the recent reduction of marginal reserve requirements on large CD's.

Mr. Eastburn said he thought the Chairman's statement was excellent. He agreed particularly with two points, of which the first was that selective approaches were required in specific areas. Selectivity was needed in dealing not only with recessionary tendencies but also with inflationary developments, and in that connection he hoped that any proposals to remove existing controls on prices and wages would be considered carefully. Secondly, he concurred in the view that any move toward ease in monetary policy should be moderate, partly because of the many prevailing uncertainties. One great uncertainty related to the degree of substitution that would take place in the spending patterns of consumers and businesses in reaction to the energy problem, and he hoped the staff would keep a close watch on developments in that area. Another reason for moderation in moving toward ease was the recent high rate of monetary growth. He would like to see the Committee act at an opportune time to reduce the growth rate to a more reasonable level.

Against that background, Mr. Eastburn continued, he favored the language of alternative A for the operational paragraph of the directive and specifications intermediate to those of alternatives A and B. For M_1 , he would prefer a target growth rate for the first and second quarters combined in the neighborhood

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of 5-1/4 per cent and a range of tolerance for the December-January period of 3 to 5-1/4 per cent. Whatever range for the Federal funds rate was believed to be consistent with those growth rates would be acceptable to him.

Mr. MacLaury remarked that he also would subscribe to the views the Chairman had expressed. The key question facing the Committee, in his judgment, was how a "modest and cautious" shift in policy should be interpreted. He believed that there had been a fundamental change in the economic outlook, and that the change would probably persist whether or not the oil embargo was relaxed. Some observers viewed the change primarily in terms of constraints on supply, about which monetary policy could do very little. While it was, admittedly, a question of emphasis, he would be inclined to put as much emphasis on the potential slackening of demand as the staff had in its presentation this morning. He anticipated major sectoral dislocations, great uncertainty, and a sharp reduction in consumer demands. While he expected more inflation than the staff did, much of the increase would be a one-time adjustment to higher-cost energy. He recognized the risk of cost-push inflationary forces developing as a result of demands for higher wages to compensate for the resulting rise in living costs; nevertheless, he thought that monetary

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policy should not do very much about a one-time price adjustment, and that it probably could not do very much about cost-push inflation.

If it were agreed that there had been a fundamental change in the economic outlook, Mr. MacLaury continued, it certainly would be appropriate for the Committee to reconsider its longer-term target path for monetary growth. Although, as the Chairman had indicated, paths such as that depicted by the "5 per cent growth" line in the blue book chart had no official status, he found them to be a very helpful device in policy deliberations. As a procedural matter, he would prefer to have such paths formulated in terms of M_2 rather than M_1 , and like Mr. Mitchell he would want the possibility to be carefully considered of basing such paths on a period longer than one month. Setting such questions aside for the time being, he believed the change in the economic outlook called for a longer-run growth path for M_1 in the range of 5-1/2 to 6 per cent rather than one in the range of 4-1/2 to 5 per cent. He favored the specifications of alternative A, on the ground that they were consistent with the objective of reaching the steeper growth path in time. The only change he would favor in the alternative A specifications would be to increase the lower limit of the range for the

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funds rate by a quarter of a percentage point, which would yield a range of 8-1/2 to 10 per cent.

In concluding, Mr. MacLaury said it was his impression that the Committee had been concerned last winter about possible reactions in the Congress if interest rates had been allowed to rise rapidly at that time. It seemed to him that there would be even greater grounds for concern about reactions if the Committee should fail to evidence in some way its recognition of the change in the economic outlook. The directors of the Minneapolis Reserve Bank did not believe that discount rate action would be appropriate at this time, but they did feel that --to use the words of Chairman Burns--a modest and cautious easing of monetary policy would be desirable.

Mr. Kimbrel said he also agreed with the Chairman's statement of the reasons for cautious easing. In meetings with groups of businessmen in various parts of the Sixth District he had found relatively little concern about the energy problem as recently as 3 weeks ago. Last week, however, he found considerably more pessimism, relating particularly to concern about accelerating inflation. He was beginning to wonder if many businessmen were not reacting to shortages and slower deliveries in a way that would tend to validate their own forecasts; they

appeared to be willing to pay almost any price for goods in short supply, and they were placing orders for far more merchandise than they could use if deliveries were made. Many were now prepared to hold inventories on a scale that would have been completely unacceptable to them a short time ago; one fast food chain, for example, had accumulated a 12-month supply of frozen fish and a 6-month supply of potatoes. The shortages they complained of were of materials and labor, not money. Even in the construction industry there was greater concern about the availability of plumbing fixtures than about the availability of funds.

Since such behavior was, of course, influenced by inflationary expectations, Mr. Kimbrel continued, he would very much regret any monetary policy actions that suggested an attempt by the System to stimulate demand. That would be particularly unfortunate at the moment because, at least in the Sixth District, demand still appeared to be adequate. Judging from the review of developments in the blue book, including the report that M_1 had grown at an 11 per cent rate in November and was estimated to be growing at a 6-1/2 per cent rate over November and December together, it seemed to him that recent monetary policy had not been restrictive. Accordingly, he saw no reason for the Committee to revise its longer-run targets for the aggregates. At the same time, he would not want to see the

Federal funds rate rise. He would favor concentrating on keeping money market rates from advancing, even at the risk of some undesired expansion of the aggregates. For the near term, at least, he thought the specifications and the language of alternative B were appropriate.

Mr. Black observed that his own views had been expressed very well by Chairman Burns. He subscribed not only to the Chairman's comments but also to those of a number of other speakers today. In his judgment, the safest policy course now would be to hold rather closely to the longer-run target growth rate for M_1 of 5 per cent. If the expected slowdown in activity that now appeared to be almost inevitable did develop, the transactions demand for money would decline, so that maintenance of monetary growth at the target rate would automatically involve an easing of money market conditions. At the same time, adherence to the target growth rate would provide some insurance against premature easing, in the event that activity was better sustained by substitutions than seemed likely at the moment.

Mr. Black remarked that he favored the directive language of alternative B. However, he would shade the specifications a little towards those of alternative A, largely because he saw no great advantage in trying to compensate for the fourth-quarter

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overshoot in the aggregates, to which special factors had contributed. Specifically, he would set the 6-month targets for M_1 and M_2 , respectively, at 5 and 7-1/2 per cent, and the December-January ranges of tolerance for those aggregates at 3 to 6 and 5 to 8 per cent.

Mr. Balles said he wanted to associate himself not only with Chairman Burns' remarks of this morning but also with the Chairman's recent statement to a Congressional committee to the effect that the country at present was suffering from a shortage of oil, not money. He concurred in the view that fiscal rather than monetary tools would have to be the main means of coping with the pending economic problems and that the contribution of monetary policy would necessarily be limited. On the one hand, it was vital that monetary policy not exacerbate rising inflationary pressures by adding excessively to aggregate demand. On the other hand, it seemed clear to him that monetary policy should not be tightened in an effort to offset the price increases that stemmed from supply shortages, of which oil was the most spectacular instance. He concluded that, however painful it might sound, the System had no choice but to validate price increases that stemmed from supply shortages, because a failure to do so would probably result in unacceptable declines in production, income, and employment.

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In his view, Mr. Balles continued, some moderate increase in the growth rate of money from that recently experienced was necessary, in order to avoid a shrinkage in the real money supply. In response to his earlier request, Mr. Axilrod had given him figures indicating the annual rate of growth for the second half of 1973, calculated by relating the estimated average level in the fourth quarter to the level in the second quarter. On that basis, M_1 and M_2 grew over the second half at annual rates of 5.1 and 8.6 per cent, respectively, compared with the rates of 3.5 and 7.7 per cent calculated by relating the estimated December level to that of June. He favored the language of alternative B, which called for "somewhat more growth" in the aggregates than currently estimated for the second half of 1973. On the basis of quarterly-average calculations, however, that statement would be consistent with the growth paths for the first half of 1974 associated with alternative A rather than with those of B. Accordingly, he was inclined toward the specifications of alternative A for the aggregates, both the longer-run targets and the 2-month ranges of tolerance. As to the range for the Federal funds rate, however, he thought the lower limit shown under A--8-1/4 per cent--was lower than necessary.

Mr. Holland said it now appeared that economic activity in the year ahead would be subject to a little more disruption in supply, a little more shrinkage in demand, and a little more cost-push pressure on prices than he, at least, had considered likely a month ago. In his opinion, the likely recession in economic activity was sufficiently large to call for some monetary adaptation, and the likely post-embargo snap-back would not be so abrupt as to render any monetary easing during this interval ill-advised. He would, however, want to move cautiously, because of the uncertainties in the present situation and the possibility of a snap-back.

In his view, Mr. Holland continued, moderate growth in the monetary aggregates, together with gently declining interest rates, would be a useful prescription for policy at this point. He would be inclined to place greater stress on the desirability of achieving more ample growth in M_2 and M_3 than in M_1 , because the former aggregates were more closely related to the areas of economic activity on which a little monetary easing was likely to have a salutary effect. As to the 6-month target for M_1 , he favored the 4-1/2 per cent figure of alternative B, which was consistent with the longer-run growth path adopted by the Committee at its previous meeting. While he was not persuaded

that that path would remain proper for long, one of the virtues of retaining it at this juncture was that it would mean a somewhat more ample supply of money relative to the level of activity if, as the staff projected, nominal GNP grew less in coming quarters than had been anticipated earlier.

Mr. Holland observed that he was prepared to apply a touch of easing now--to take what amounted to a beginning step in that direction. With respect to directive language, he had planned to express a preference for alternative B until Mr. Balles had commented on the rates of growth in the monetary aggregates calculated on a quarterly-average basis. He was now inclined to believe that the safest, if not the most imaginative, course would be to call for "moderate growth in monetary aggregates," as the Committee had often done in the past. As to short-run specifications, he would favor those of alternative B with the upper limits of the December-January ranges of tolerance for the aggregates raised by one percentage point, so that the Desk would not be obliged to tighten conditions if the rate of decay of some of the recent temporary bulges should prove to be a little slower than expected. In particular, for M_1 and M_2 he would favor 2-month ranges of 3 to 6 and 5 to 8 per cent, respectively. He would also counsel the Manager to discount any changes in RPD

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growth that were attributable to a larger-than-expected expansion in CD's because such a development, in his view, would be of secondary importance.

Finally, Mr. Holland observed, he would like to achieve the modest easing he advocated by instructing the Manager to take the initiative in starting to move the Federal funds rate down within the alternative B range, so long as the growth rates in the aggregates were not crowding the upper limits of the widened ranges specified for them. A shading down of the funds rate from 10-1/4 to about 9-3/4 per cent by the time of the Committee's next meeting would seem about right to him in the current environment. There was a possibility, although probably not a strong one, that such a course might set off another rally in the securities market of the kind that developed in response to the System's easing actions following the September meeting. In that event, he would be agreeable to halting the move toward ease. He would not want to lose the sense that some easing had occurred, however, and accordingly would not want the Desk to move vigorously against any rally that might develop.

Mr. Coldwell remarked that the oil shortage was having a favorable effect on all activities in the Eleventh District associated with oil. Well drilling, especially in West Texas,

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was being limited only by the availability of drilling rigs and crews, abandoned wells were being uncapped, and refineries were operating at full capacity. There was a shortage of labor in the District that was becoming quite troublesome; the unemployment rate had fallen to the neighborhood of 2 per cent in most of the major cities, and even along the Mexican border, where the unemployment rate typically was in the 10 to 12 per cent range, it had fallen to the neighborhood of 5 or 6 per cent.

Nationally, Mr. Coldwell continued, there were great uncertainties with respect to the impact of the oil shortage. One certainty, however, was that prices would rise further. He thought it was likely that the stimulus to price advances would proliferate beyond the oil-related areas. That, at least, was suggested by a brief survey of 200 Texas companies recently made by the Dallas Reserve Bank. The survey indicated that stockpiling, not only of oil but of almost all raw materials used in production, was proceeding on a massive scale.

As far as monetary policy was concerned, Mr. Coldwell observed, he was reluctant to move very far very fast in light of the many prevailing uncertainties and in light of the certainty that prices would be under upward pressure. In considering the

short-run specifications shown in the blue book under the various alternatives, he had been struck by the small spread of the 2-month ranges of tolerance for the aggregates; indeed, one could almost make a case for specifying ranges that extended from the lower limits shown under alternative C to the upper limits shown under A. If he were to choose among the alternatives, however, he would favor the specifications of alternative B with a wider band. Like Mr. Holland, he would prefer a directive that called for "moderate growth in monetary aggregates," primarily because he was concerned about the risk of fostering the view in financial markets that the Federal Reserve was opening the monetary spigot wide in reaction to the energy crisis. Some feeling to that effect was already discernible, not only in the markets but also among Reserve Bank directors.

Chairman Burns commented that it would be helpful at this point to have the policy recommendation of the Committee's Senior Economist.

Mr. Partee said he thought it would be desirable at this juncture for the System to become somewhat more liberal in the provision of money and credit to the economy than it had been earlier. Specifically, he would recommend that the Committee adopt as its longer-run target for M_1 the 6 per cent

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growth rate which was assumed in the alternative projection he had discussed in his statement earlier today. One reason for that view was that the increase in oil prices was likely to add nearly a full percentage point to the rate of increase in the GNP deflator. Assuming that the Committee would want to accommodate the advance in oil prices--that is, assuming it would not seek to offset that advance by putting downward pressure on other prices--the oil price increase alone would call for raising the targeted M_1 growth rate from 5 to nearly 6 per cent. In his judgment, such an adjustment should be viewed not as a shift to a more expansive policy but simply as an allowance for an advance in one segment of the price structure that, while regrettable, had to be permitted.

Secondly, Mr. Partee continued, it was true, as Mr. Hayes had observed, that hard evidence was not yet in hand of emerging weakness in economic activity. However, the omens of such a development were very strong. The red book was compiled in part to provide clues to the likely course of activity in advance of statistical evidence, and the current edition reflected concerns about weakness in such areas as housing in subdivisions far from central cities, vacation housing, and recreational vehicles, as well as in the auto market. It seemed to him that every logical

power one might apply to the question suggested that the expectation of weakness in such areas would shortly be confirmed by statistical evidence. In his judgment, there was not much time to be lost in modifying policy in view of existing lags--particularly, in the present situation, the lag that would occur before the residential construction industry could make such adaptations as building close to central cities rather than at a distance and building high-rise apartments rather than single-family homes.

For those reasons, Mr. Partee observed, he felt rather strongly that the alternative A specifications would be appropriate at this time. The Committee might prefer to raise the lower limit for the funds rate from the 8-1/4 per cent figure of alternative A on the grounds that a reduction to that level in a 5-week period would be too abrupt a move. But a considerable reduction in the funds rate might be necessary if, as he expected, weakness in the monetary aggregates began to develop early in the weeks and months ahead.

Mr. Morris said he wanted to associate himself with the views expressed by Mr. Partee as well as with those offered earlier by Messrs. MacLaury and Balles. He believed the Committee should gear its policy to the extremely high probability that the economy was moving into a recession, although that recession

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would be of a peculiar sort in which monetary policy could play a less powerful role than in the classical kind. In his view it would be appropriate at this juncture, as a short-term matter, for the Committee to place primary emphasis on interest rates and to promote gradual downward pressure on rates. He agreed with the Chairman on the need for proceeding cautiously in the sense that he would not want to pursue such an interest rate policy to the point of risking loss of control over the rate of growth of the monetary aggregates. If, however, the staff's economic projections were at all close to the mark, the risk of generating excessive growth in the aggregates in the first half of 1974 was very low. The real risk, in his view, was that growth in the aggregates would fall short of the Committee's objectives because of a mistaken effort to oppose a natural downward tendency in interest rates of the kind that had typically been associated with slackening economic activity in the past. In that connection, he was inclined to believe that the reduction in interest rates needed to generate growth in the money supply at a 5 or 6 per cent annual rate would prove to be greater than suggested in the blue book.

Against that background, Mr. Morris observed, he would support alternative A, except that he would set the upper limit

for the Federal funds rate at 9-3/4 per cent. By so doing the Committee would, in effect, be instructing the Manager to begin in a small way to place downward pressure on interest rates; subsequently, he would be expected to gear the change in the funds rate to developments in the monetary aggregates.

Mr. Morris added that he was a little confused about the position of those speakers who had indicated that they concurred in the Chairman's acute analysis of the present situation and then expressed a preference for the alternative B specifications. As he interpreted those specifications, they represented a status quo policy, not even the type of modest change the Chairman had recommended.

Mr. Bucher said he had little to add to the fine statements just made by Mr. Partee and Mr. Morris. He concurred in their view that a serious recession was a good possibility, and he expected that recession to be associated with many dislocations. He also thought the Chairman's statement of this morning was an excellent one. Like the Chairman, he would favor a cautious policy move, but he wanted to make sure that that move took place. He would be inclined to stress the matter of public psychology more than other speakers had. Earlier, the Chairman had referred to the strong positive effects on attitudes that would flow from a

near-term end to the oil embargo. But attitudes could also have negative effects, and he thought that current attitudes were accurately reflected by the recent declines in stock market prices.

Mr. Bucher remarked that, while an easing of credit would not resolve problems of shortages, it could have other useful consequences, particularly in the mortgage market. He would like to see increased residential construction activity as an offset to some of the spending lags in other areas.

Mr. Bucher observed that he wholeheartedly supported the specifications of alternative A, except that--like Mr. Morris-- he would reduce the upper limit for the funds rate a bit in order to make clear to the Manager that the Committee wanted him to move in the direction of easing money market rates. He also found the alternative A directive language satisfactory. With respect to Mr. Holland's suggestion for the directive, he had never been particularly happy about language calling for "moderate growth" in the aggregates. However, he did not feel strongly about the matter at this point.

Mr. Mitchell said he shared Mr. Morris' confusion about the position of some of those who had concurred in the Chairman's statement, which he had interpreted as calling for a cautious--

but definite--move in the direction of easing. He preferred the directive language of alternative A because it indicated more clearly than B that the Committee was changing policy, but he was less sure about the appropriate specifications. He was more pessimistic about the economic outlook than most, and he would favor giving the market some kind of signal that would set in motion forces working in the proper direction. A move toward ease would be useful in stimulating increased flows of savings funds to banks and other thrift institutions, and he would not be greatly disturbed at this point by a sharp acceleration in the growth of M_1 , M_2 , or M_3 . At a minimum, he would want to raise the upper limits of the short-run ranges for the monetary aggregates shown under alternative B, as Mr. Holland had suggested. As to the Federal funds rate, he would be inclined to set the lower limit at 8-3/4 per cent and to instruct the Manager to aim at a rate a little below 10 per cent in the near term.

Mr. Mitchell added that almost all members appeared to favor giving some kind of signal of easing, differing only on the question of the precise form of that signal. He suspected that the Committee might have been able to conclude its deliberations quickly this morning if the Chairman had followed his statement with a description of the specifications he thought were implied by his general policy prescription.

Chairman Burns remarked that he might indicate the specifications he had in mind at this point. In general, they fell between those shown under alternatives A and B in the blue book, and were as follows: the 6-month targets for annual rates of growth in M_1 , M_2 , and the credit proxy would be 5-1/4, 8, and 9-1/4 per cent, respectively; the December-January ranges of tolerance for growth rates in RPD's, M_1 , and M_2 would be 8-1/4 to 10-3/4, 3 to 5-1/2, and 5 to 7-1/2 per cent, respectively; and the range for the Federal funds rate would be 8-3/4 to 10 per cent.

Mr. Brimmer observed that, as the members knew, he had cautioned at recent meetings against pressing toward ease because he thought such action would have been premature. He no longer held that view. The choice now facing the Committee was between letting monetary policy act as a constraint on an economy that was struggling to adjust or using policy to facilitate the adjustment, and he favored the latter course. When the Board had met with its academic consultants in early December, the latter-- although speaking from a variety of viewpoints--had reached a consensus about appropriate policy essentially the same as that which was emerging among Committee members today. The Economic Policy Committee of the OECD had struggled with a similar question

at its meeting in mid-November, but in his opinion it had arrived at the wrong conclusion. In his view, there was a chance of a generalized recession, affecting not only the United States but the rest of the world as well.

Mr. Brimmer commented that some analytical work he had been doing suggested that a longer-run growth rate in the money supply of 5 per cent would be inadequate if the GNP deflator were rising at a rate a little over 5 per cent, as now appeared likely for the year 1973. Such a growth rate would be even more inadequate if the deflator were to rise at a rate well in excess of 6 per cent, as was projected for 1974. Accordingly, he thought the Committee should take the deliberate step of increasing its longer-run targets. It was important that the Committee not restrict its vision to the evidence in hand about current economic developments; it should be looking ahead to the time when events now in train would be having their effects on the economy. He thought the time to act had come.

In conclusion, Mr. Brimmer said he had originally interpreted the Chairman's earlier comments on policy to call for the adoption of the alternative A specifications. He was fully prepared, however, to subscribe to the specifications intermediate to those of A and B which the Chairman had just suggested.

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Mr. Daane remarked that he had been impressed on his recent trip to Europe with the fact that foreign central bankers were generally striving to determine the appropriate role for monetary policy in the unique situation facing industrial countries at present. He was completely in accord with the Chairman's description of the appropriate role for U.S. monetary policy at this juncture, particularly with the suggestion that the Federal Reserve should begin to move now in a cautious and restrained way. To his mind, the language of both alternative A and B, calling respectively for "more" and "somewhat more" growth in the monetary aggregates than in the second half of the year, failed to capture the desired connotation of caution. After thinking about that problem, and also about the comments made by Mr. Morris, he had concluded that the Committee's intent would be reflected better in a directive which called for probing cautiously toward slightly easier money and credit conditions. Specifically, he would suggest the following language for the operational paragraph: "To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to probe cautiously toward slightly easier bank reserve and money market conditions consistent with more growth in monetary aggregates over the months

ahead than is currently estimated for the second half of 1973." Specifications between those of alternatives A and B, such as the Chairman had suggested, would be consistent with such a directive, but in his view the language in itself captured the essence of the Committee's consensus as he interpreted it.

Mr. Clay said he concurred in the Chairman's statement about the appropriate role of monetary policy under present circumstances. What the Committee should be trying to do at this time could be summarized as feeding the nation's economy to the extent it had the capacity to produce and starving the inflation. That extraordinarily difficult assignment would require not only caution but also a great deal of both skill and good fortune. And, in his judgment, it suggested the adoption of the alternative B policy course today. Contrary to the views of Messrs. Morris and Mitchell, he saw no inconsistency between the statement the Chairman had made before luncheon and the specifications of alternative B, because the growth rates of the monetary aggregates recently had been running above the Committee's longer-run targets. Under those circumstances, it could not be said that the Committee was starving the economy of money and credit.

Mr. Sheehan remarked that he was somewhat troubled by the specifications the Chairman had proposed because it was not

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obvious to him that they would result in a movement toward ease of the kind most members had indicated they favored. One question in his mind was how the Manager would interpret those specifications. At the September meeting, he recalled, the Committee also had concluded that some easing would be desirable. However, the Manager's subsequent efforts to accomplish that objective had been constrained by a clause in the directive instructing him to take account of conditions in domestic financial markets. A second question was whether a short-run target range of 3 to 5-1/2 per cent for growth in M_1 would actually constitute easing; it was his impression that M_1 recently had been growing at a substantially faster rate.

In reply to a question by the Chairman, Mr. Axilrod noted that M_1 had, indeed, grown rapidly in November--at a rate close to 11 per cent. If current interest rates were maintained, however, the staff would expect the growth rate to fall sharply in December--to the neighborhood of 2 per cent--and to remain quite modest over the first quarter. That was the basis for the staff's conclusion that a decline in interest rates would be required if the aggregates were to grow at the rates called for under either alternative A or B.

Chairman Burns remarked that it might be helpful if he were to indicate his thinking with respect to the Federal funds rate. As of today, at least, he would like to see the funds rate decline by the time of the next meeting to the 9-1/2 to 9-3/4 per cent area.

Mr. Sheehan commented that he would find such an outcome acceptable. What had troubled him was the possibility that the temporary phenomena which produced strong M_1 growth in November might persist for another 6 to 10 weeks and that, as a consequence, the funds rate might be kept at the top of the specified range.

The Chairman then asked Mr. Holmes for his response to Mr. Sheehan's question concerning the manner in which he would interpret the proposed specifications.

Mr. Holmes replied that, in accordance with his understanding of the discussion thus far, the Desk would be expected over the next 10 days or so to lower the funds rate progressively from its current level near 10-1/8 to about 9-3/4 per cent. If at that point the monetary aggregates appeared to be weak, some further reduction in the funds rate would be sought; if they appeared to be strong, the reduction would be brought to a stop. If the aggregates were extremely strong, the Chairman presumably would consider the desirability of Committee consultation.

Mr. Hayes said he was puzzled by the Chairman's proposal of an 8-3/4 per cent lower limit for the funds rate in view of the latter's statement that he would like to see the rate in the 9-1/2 to 9-3/4 per cent area at the time of the next meeting.

Chairman Burns observed that, while he considered such an outcome for the funds rate desirable at the moment, developments during the period with respect to the monetary aggregates would have to be taken into account. If, for example, the aggregates were to begin growing at explosive rates he would not favor a funds rate below 10 per cent, at least in the absence of some other overriding consideration.

Mr. Winn said he concurred in the Chairman's statement about the role of monetary policy at this time and he agreed with the specifications the latter had suggested. He would take the time now only to call attention to two problems he thought lay ahead. First, float was likely to be highly volatile in coming months because of transportation problems. Since that would increase the difficulties of projecting the relationships with which the Manager worked, the Committee should be prepared to widen the ranges of tolerance it specified for the Manager's guidance. Secondly, retailers were reporting a considerable increase in the ratio of cash to credit sales during the current

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Christmas shopping season. If, as that suggested, a basic shift was under way in the payments practices of the public, there obviously would be implications for the Committee's longer-run targets for monetary aggregates.

Chairman Burns remarked that the System should be alert to the possibility of a change in payments practices.

The Chairman then referred to the language Mr. Daane had suggested earlier for the operational paragraph of the directive and asked whether the members had any reactions they cared to express.

Mr. Mitchell said he was not happy with the proposed instruction to "probe cautiously" toward slightly easier conditions.

Mr. Sheehan remarked that the language in question struck him as much too mild.

Mr. Daane observed that he held no particular brief for the specific phrasing. His interest was in arriving at a formulation for the directive which captured the sentiment of the Committee better than any of the staff's drafts.

Chairman Burns remarked that his thinking had been running along similar lines; indeed, before Mr. Daane had made his suggestion he had been considering the possibility of proposing the following directive language: "To implement this policy, while

taking account of international and domestic financial market developments, the Committee seeks to achieve some easing in bank reserve and money market conditions, provided that the monetary aggregates do not appear to be growing excessively." In his judgment, either Mr. Daane's proposal or his own would convey the Committee's consensus today more accurately than either alternative A or B. His only reason for hesitation in recommending such language was that it would involve a shift from the kind of directive--in which primary emphasis was placed on the monetary aggregates--that the Committee had been employing more or less successfully for some time. If he were confident that the Committee would be prepared to return to the customary type of directive at subsequent meetings, he would strongly urge the adoption today of language along the lines of Mr. Daane's proposal or his own.

Mr. Daane expressed the view that the language the Chairman had read would serve the purpose he had in mind. He added that at times in the past the Committee had shifted back and forth between directives placing primary emphasis on the aggregates and on money market conditions.

After some further discussion, the Chairman called for expressions of preference among the various proposals under consideration for the operational paragraph of the directive. It

developed that a majority of the members preferred the language the Chairman had read.

In the ensuing discussion of specifications, Mr. Hayes said he was still troubled by the proposal that the lower limit for the Federal funds rate be set at 8-3/4 per cent. He asked about the circumstances that would be expected to require a reduction in the funds rate to that level by the time of the next meeting.

Mr. Holmes said it was his understanding that the lower end of the proposed range for the funds rate would be used only if the monetary aggregates were extremely weak.

Mr. Daane concurred in the Manager's statement.

Mr. Mitchell said he thought the more likely possibility was that the aggregates--particularly M_2 --would grow at rates above the upper limit of the 2-month ranges the Chairman had proposed. He would favor increasing those upper limits somewhat.

Mr. Holland noted that, given the proposed directive language, the upper limits of the 2-month ranges would, in effect, demarcate the range of growth rates defined as "excessive." He agreed with Mr. Mitchell that those proposed by the Chairman were a little low.

Chairman Burns remarked that the upper limits of the 2-month ranges for the monetary aggregates might each be raised by one-half of a percentage point, so that the ranges of tolerance for M_1 and M_2 would be 3 to 6 and 5 to 8 per cent, respectively. The upper limit of the RPD range might be set at 11 per cent, yielding a range of 8-1/4 to 11 per cent.

In response to the Chairman's inquiry, a majority of the members indicated that they would favor such an adjustment of the 2-month ranges for the aggregates.

Mr. Brimmer said it was not clear to him whether the Committee would expect the Manager to act vigorously in reducing the Federal funds rate or to proceed more cautiously.

Mr. Sheehan referred to the statement he had made earlier that a reduction in the Federal funds rate to the 9-1/2 to 9-3/4 area by the time of the next meeting would be acceptable to him. He wondered, however, whether that would be a sufficiently large move. As he sensed the feelings of a majority of the members, they would favor a funds rate closer to 9 per cent by mid-January unless the monetary aggregates were growing at explosive rates.

Mr. Daane remarked that that was not consistent with his own interpretation of the sentiment of the majority.

Mr. Mitchell commented that the particular funds rate sought should depend on developments with respect to the aggregates.

Chairman Burns observed that Mr. Brimmer's question might be answered by considering the upper limit set for the funds rate. He asked for expressions of preference between the 10 per cent limit he had originally proposed and a limit of 9-3/4 per cent.

A majority of the members indicated that they preferred to set the upper limit at 10 per cent.

The Chairman then referred to Mr. Hayes' earlier suggestion that language be added to the first paragraph of the draft directive regarding the likely effect of the oil crisis on prices. That might be done by revising the sentence reading "Further weakening is in prospect because of the curtailment of oil supplies" to read "A further weakening in activity and an appreciable rise in prices are in prospect because of the curtailment in oil supplies."

There was general agreement with the suggested revision.

Chairman Burns proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs, with the revision just agreed upon, and the language he had read for the operational paragraph. It would be understood that that

directive would be interpreted in accordance with the following specifications. The longer-run targets--namely, growth rates for the first and second quarters combined--would be 5-1/4, 8, and 9-1/4 per cent for M_1 , M_2 , and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the December-January period would be 8-1/4 to 11 per cent for RPD's, 3 to 6 per cent for M_1 , and 5 to 8 per cent for M_2 . The range for the weekly-average Federal funds rate in the inter-meeting period would be 8-3/4 to 10 per cent.

Mr. Hayes said he planned to cast a dissenting vote.

With Mr. Hayes 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 domestic policy directive:

The information reviewed at this meeting--including recent developments in industrial production, residential construction, and retail sales--suggests that growth in economic activity is slowing in the fourth quarter. A further weakening in activity and an appreciable rise in prices are in prospect because of the curtailment in oil supplies. In November nonfarm payroll employment expanded further, but the unemployment rate, which had dropped in October, rose again to about the level that had prevailed since midyear. Wholesale prices of industrial commodities continued to rise sharply in November, reflecting large additional increases for petroleum products and widespread advances among other commodities; farm and food prices declined further.

In nearly all industrial countries abroad, concern has grown that a sustained cut in oil supplies will disrupt economic activity. Major foreign currencies have depreciated further against the dollar, and intervention sales of dollars by foreign monetary authorities have continued. The U.S. merchandise trade balance registered a strong surplus in the September-October period.

The narrowly defined money stock, following little net change over the third quarter, has grown at a relatively rapid pace over the past 2 months. Growth in the more broadly defined money stock has also been substantial, as net inflows at banks of consumer-type time deposits have been large. Net deposit inflows at nonbank thrift institutions improved somewhat further. Bank credit expansion remained moderate in November, although business loans increased after 2 months of little or no growth. On December 7 the Federal Reserve announced a reduction from 11 to 8 per cent in marginal reserve requirements on large-denomination CD's. Most short-term market interest rates have declined somewhat on balance in recent weeks, while movements in long-term market rates have been mixed.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, cushioning the effects on production and employment growing out of the oil shortage, and maintaining equilibrium in the country's balance of payments.

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve some easing in bank reserve and money market conditions, provided that the monetary aggregates do not appear to be growing excessively.

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 Mr. Hayes submitted a summary statement of his reasons for dissenting from the directive, which he asked be incorporated in the record. He indicated that, with inflation still the number one problem, and with the aggregates apparently growing more rapidly in 1973 than the Committee had considered desirable, he favored a continuation of the current degree of monetary restraint without noticeable relaxation unless signs of weakening in the economy become more apparent. There was not much monetary policy could do to relieve the economic problems arising from the oil shortage, but a premature easing of policy could exacerbate the problems of inflation.

Chairman Burns expressed the view that the Committee had reached a sound decision today. He added that the present period was a critically important one, and that during the next few weeks the members should stand ready to communicate with one another concerning any new developments or new thoughts.

It was agreed that the next meeting of the Committee would be held on January 22, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.


Arthur L. Branda
Secretary

ATTACHMENT A

December 17, 1973

Drafts of Domestic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on December 17-18, 1973

GENERAL PARAGRAPHS

The information reviewed at this meeting--including recent developments in industrial production, residential construction, and retail sales--suggests that growth in economic activity is slowing in the fourth quarter. Further weakening is in prospect because of the curtailment of oil supplies. In November nonfarm payroll employment expanded further, but the unemployment rate, which had dropped in October, rose again to about the level that had prevailed since midyear. Wholesale prices of industrial commodities continued to rise sharply in November, reflecting large additional increases for petroleum products and widespread advances among other commodities; farm and food prices declined further.

In nearly all industrial countries abroad, concern has grown that a sustained cut in oil supplies will disrupt economic activity. Major foreign currencies have depreciated further against the dollar, and intervention sales of dollars by foreign monetary authorities have continued. The U.S. merchandise trade balance registered a strong surplus in the September-October period.

The narrowly defined money stock, following little net change over the third quarter, has grown at a relatively rapid pace over the past 2 months. Growth in the more broadly defined money stock has also been substantial, as net inflows at banks of consumer-type time deposits have been large. Net deposit inflows at nonbank thrift institutions improved somewhat further. Bank credit expansion remained moderate in November, although business loans increased after 2 months of little or no growth. On December 7 the Federal Reserve announced a reduction from 11 to 8 per cent in marginal reserve requirements on large-denomination CD's. Most short-term market interest rates have declined somewhat on balance in recent weeks, while movements in long-term market rates have been mixed.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, cushioning the effects on production and employment growing out of the oil shortage, and maintaining equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with more growth in monetary aggregates over the months ahead than is currently estimated for the second half of 1973.

Alternative B

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat more growth in monetary aggregates over the months ahead than is currently estimated for the second half of 1973.

Alternative C

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with slightly less growth in monetary aggregates over the months ahead than is currently estimated for the second half of 1973.

ATTACHMENT B

December 18, 1973

Points for FOMC guidance to Manager
in implementation of directive

Specifications
(As agreed, 12/18/73)

-
- A. Longer-run targets (SAAR):
(first and second quarters combined)
- | | | |
|--|----------------|--------|
| | M ₁ | 5-1/4% |
| | M ₂ | 8% |
| | Proxy | 9-1/4% |
- B. Short-run operating constraints:
1. Range of tolerance for RPD growth rate (December-January average): 8-1/4 to 11%
 2. Ranges of tolerance for monetary aggregates (December-January average):
M₁ 3-6%
M₂ 5-8%
 3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings): 8-3/4 to 10%
 4. Federal funds rate to be moved in an orderly way within range of toleration.
 5. Other considerations: account to be taken of international and domestic financial market developments.
- C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.