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 16-17, 1974, beginning at 4:00 p.m. on Monday.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Black
Mr. Bucher
Mr. Clay
Mr. Coldwell
Mr. Holland
Mr. Kimbrel
Mr. Mitchell
Mr. Sheehan
Mr. Wallich
Mr. Winn

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

Messrs. Eastburn, Francis, and Balles, Presidents of the Federal Reserve Banks of Philadelphia, St. Louis, and San Francisco, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Solomon, Economist (International Finance)
Messrs. Brandt, Bryant, Davis, Doll, Gramley, Hocter, Parthemos, Pierce, and Reynolds, Associate Economists

Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Wonnacott, Associate Director, Division of International Finance, Board of Governors
Mr. O'Brien, Special Assistant to the Board of Governors
Messrs. Keir, Kichline, and Wernick, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, Adviser, Division of International Finance, Board of Governors
Mr. Zeisel, Associate Adviser, Division of Research and Statistics, Board of Governors
Mrs. Junz, Associate Adviser, Division of International Finance, Board of Governors
Messrs. Taylor and Wendel, Assistant Advisers, Division of Research and Statistics, Board of Governors
Messrs. Siegman and Truman, Assistant Advisers, Division of International Finance, Board of Governors
Mr. Peret, Assistant to the Director, Division of Research and Statistics, Board of Governors
Mr. Smith, Chief, Financial Markets Section, Division of International Finance, Board of Governors
Messrs. Beeman and Enzler, Senior Economists, Division of Research and Statistics, Board of Governors
Mr. Roxon, Senior Economist, Division of International Finance, Board of Governors
Mr. Annable, Economist, Division of Research and Statistics, Board of Governors
Miss Morisse, Economist, Division of International Finance, Board of Governors

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

Mr. Rankin, First Vice President, Federal Reserve Bank of Richmond
Messrs. Eisenmenger, Boehne, and Scheld, Senior Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and Chicago, respectively
Messrs. Jordan and Green, Vice Presidents, Federal Reserve Banks of St. Louis and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco

Chairman Burns welcomed Mr. Baughman to his first meeting of the Open Market Committee since he had been named President of the Federal Reserve Bank of Dallas. He noted that Mr. Baughman was a long-standing member of the Federal Reserve family and had attended Committee meetings in the past as an officer of the Federal Reserve Bank of Chicago.

Secretary's note: Prior to this meeting Mr. Baughman had been elected as alternate member of the Committee representing the Federal Reserve Banks of Atlanta, St. Louis, and Dallas, to fill the unexpired portion of the one-year term ending February 28, 1975, and had executed his oath of office.

Chairman Burns noted that the staff's report on the economic and financial situation at this meeting would take the form of a chart presentation. He asked Mr. Partee to begin the presentation.

Mr. Partee made the following introductory statement:

The purpose of today's meeting is to review and discuss the staff's updated economic projections, which were detailed in the green book,[1/] and to examine the possible consequences of various alternative public policy strategies. Because of the rapidly changing economic situation, both at home and abroad, it is especially important to evaluate where our economy stands at the present time. Therefore, before turning to the projection and to its possible implications for policy, Mr. Gramley first will examine the state of the economy and Mr. Reynolds the world economic setting as it impinges on us.

Mr. Gramley made the following comments:

Incoming economic statistics indicate a marked deterioration since the end of the summer in the condition of the national economy. New orders for durable goods, in real terms, peaked a year ago, but began to fall sharply in September--much as they did in the early months of the 1969-70 recession. New car sales have been extremely weak this fall, and retail sales outside of autos have also been soggy. Permits for residential buildings, meanwhile, have continued to decline along the downward path that began early in 1973.

Recently, weaknesses have shown up in a dramatic way in employment and output. Industrial production earlier this year had been moving generally sideways, as weakness in consumer durables and construction

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

products was counterbalanced by increasing output of business equipment. In October, industrial output declined moderately, but last month cutbacks in production were widespread, and the total index fell by 2.3 per cent--of which only three-tenths is attributed directly to the coal strike. The length of the average workweek in manufacturing also dropped further last month, as did factory employment, and the unemployment rate rose sharply. Moreover, there are large further declines in employment occurring in December, judging by announced layoffs in autos and other industries and the further sharp rise in the latest figures on initial claims for unemployment insurance.

The recent intensification of recessionary forces has brought with it a marked change in business inventory policies. The ratio of inventories to GNP final sales, in real terms, has been rising since early 1973, and is now very high by standards of recent years--higher than at the end of the 1969-70 recession. But the business community did not express much discomfort with the level of inventories until fairly recently--probably because prices were skyrocketing and scarcities continued to be prevalent until last summer or early fall. The series on vendor performance--which indicates the per cent of companies in the Chicago area reporting slower deliveries--actually reached its peak over a year ago, but it did not drop below the 1969 peak until this summer. Of late, the index has been falling rapidly in response to an improving supply situation, and the attitudes of businesses toward inventories also have been undergoing a marked change. Comments in the red book[1/] and elsewhere indicate that business firms in many lines are now making strenuous efforts to pare their stocks by cutting production, canceling orders, postponing receipts of goods, and making shipments ahead of promised delivery dates.

Businesses are also scaling down their fixed investment plans. New orders for nondefense capital goods, in constant dollars, have dropped about 18 per cent

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

over the past 3 months--almost as large a decline as in the entire 1969-70 recession. Construction contract awards--the floor space series--are also in a downward trend for both commercial and industrial buildings. The bearish story told by these series is reflected in the latest Commerce survey, which indicates a deterioration of capital spending plans and a probable decline in real business fixed capital expenditures in the first half of next year.

To be sure, there is still considerable strength evident in the investment plans of major materials producers. But there is also unusual weakness in electric utilities, in commercial construction, and in demands for trucks. And announced reductions or cancellations of capital spending plans by industrial firms are accelerating. Our staff tally of newspaper and other published reports here at the Board indicates a larger volume of cancellations by industrial firms in November than during the entire first 10 months of the year.

These developments in the business sector are related to more fundamental underlying weaknesses in residential construction and in consumer purchases of goods since early 1973. Relatively speaking, the decline in real goods purchased by consumers has been much less than the falloff in residential construction. But the absolute magnitudes were similar during the period from the first quarter of 1973 to the third quarter of this year. In 1958 dollars, goods purchases of consumers fell $12 billion over this period, while residential construction declined $11-1/2 billion. In the fourth quarter of this year, real durable goods purchases are declining as fast as residential construction in relative terms, and much more in absolute amounts.

A falloff in residential construction during the course of a business expansion is, of course, a familiar phenomenon associated with rising interest rates and tight credit conditions. The pronounced weakness we have seen in real consumer purchases of goods since the spring of 1973, however, is unusual. It probably reflects a variety of factors--supply scarcities that retarded economic expansion, the energy crisis, and waning consumer confidence. An important consideration, however, is the effect of inflation on consumers' real income, including the substantial drain of purchasing power to the OPEC countries caused by the higher price of oil.

Real disposable income per household began to turn around the middle of 1973, and since then has fallen about 5 per cent. In the postwar period, declines of this magnitude have been rare. Real disposable income of households went down less during the recessions of 1953-54, 1957-58, and 1969-70, than it did during the past year. Actually, there is only one other period in postwar history--the year from mid-1946 to mid-1947--when real household income declined as much or more than we have seen recently. Then, as now, controls had been lifted and prices were rising rapidly.

Inflation has eroded the strength of demand in the private sector in yet another way--through its influence on economic policy. Early in 1973, the rate of inflation began to exceed the rate of growth of the nominal money stock, so that real money balances began to decline. By the fourth quarter of this year, the real money stock had dropped about 8 per cent from its earlier peak. Previous declines in the real money stock during the postwar period usually were followed by recession.

During this recent period of declining real money balances, there has also been a marked shift toward surplus in the high employment budget, as inflation has increased Federal receipts while expenditures were being restrained. It is hard to know what significance should be attached to any given level of the high employment surplus or deficit. Nevertheless, the very substantial movement toward surplus since late 1972 must have been a contributing factor to the weakening of aggregate demand.

Thus, the direct and indirect consequences of inflation have led to so marked a slowing in economic activity over the past year that we now find ourselves in the midst of strong contractive forces. Other countries are in similar straits, as Mr. Reynolds' report will indicate.

Mr. Reynolds made the following comments concerning international developments:

In major industrial countries abroad, as in the United States, economic activity has weakened rapidly in recent months. Consumer spending is sluggish, investment plans are being curtailed, efforts are being made to hold down or reduce inventories, exports are leveling off or declining, and unemployment is rising.

The authorities in a number of countries--including Germany, Canada, Australia, the Netherlands, and the United Kingdom--are now moving to ease fiscal and monetary restraints. In other countries, however, including Japan, France, and Italy, the authorities do not yet feel free to relax because they are still grappling both with very serious inflationary pressures and with external payments problems. They are hoping that the United States and Germany will take the lead in resisting a cumulating world-wide recession.

Germany is well placed to take anti-recessionary actions, and is doing so. Prompt application of fiscal and monetary restraints early in the 1972-73 boom began to damp the growth in domestic demand early in 1973. Indeed, real GNP less net exports has been declining for nearly 2 years. Only a large surge in net exports kept total output from declining last year. This year, total output has declined. The unemployment rate has risen to its highest level since the late 1950's.

Meanwhile, price inflation in Germany has been relatively well contained. The cost of living index has recently been rising at only a 6-1/2 per cent rate, and price increases for industrial products have slowed to an 8 per cent rate.

Germany removed a special tax on investment late last year, and allowed an income tax surcharge to expire in mid-1974. Monetary policy began to ease in October. Forthcoming easing actions on the fiscal side include a very substantial cut in income taxes on January 1, equal to about 1-1/2 per cent of GNP, a bonus of 7-1/2 per cent on private investment projects begun by mid-1975, additional public investment, and assistance to the unemployed. The German Federal Bank has stated that growth in the monetary base of about 8 per cent during 1975, compared with 6 per cent during 1974, should be consistent with renewed economic growth and further abatement of inflation.

In Japan, output has been declining since late 1973. The petroleum crisis had particularly sharp effects on Japanese output and prices in the first quarter of this year. Since then, tight money and official requests to restrain investment outlays have brought further output declines to which inventory liquidation has contributed. The Japanese have had considerable success in slowing inflation and in reversing an earlier balance of payments deterioration. But since consumer prices are still rising at an annual rate of more than 16 per cent, and since the payments position is still viewed with concern, the authorities are not expected to ease their restraints on demand until next spring, perhaps after the April wage agreements. The decline in activity may bottom out during the first half of 1975, but little recovery is likely until the second half.

Industrial production is now also declining in Italy and Canada, and has shown little net change in the United Kingdom for nearly 2 years. In France, there has recently been some hesitation in output and considerable downward revision of investment plans.

Italy, facing rampant inflation and a serious payments problem, is trying to maintain the stringent monetary and fiscal restraints adopted last summer. France has recently intensified some restraints. Britain, also plagued by very serious inflation, has felt able only to remove in July and November the restraints that had been imposed last March. Canada, on the other hand, has recently introduced an expansionary budget and reduced interest rates.

As for the less developed countries, thus far both the OPEC and non-OPEC countries have been rapidly expanding their imports. But now the non-OPEC countries are having to tighten their belts as their export earnings and reserves decline, and this will contribute to a further weakening of world demand. Payments difficulties have already led some countries--Brazil, for example--to impose new trade restrictions.

Thus the general outlook is for some continuing decline in world economic activity at least into early 1975. We project some recovery later on in the year, but we are more than usually uncertain about these projections. The timing and strength of any pickup will depend importantly on the course of events in the larger countries--the United States, Germany, and Japan.

The current world-wide recession is beginning to be reflected in a decline in the volume of U.S. non-agricultural exports. The volume of such exports is projected to decline by about 12 per cent in the four quarters to mid-1975, and may recover only slightly during the following year. Agricultural exports are also now declining in both volume and value, reflecting low U.S. harvests. Export demand, therefore, is not expected to be an important contributing factor to recovery in our own economy.

Meanwhile, the increasing weakness of U.S. demand is reducing our imports, and thus contributing to the slowing of world trade. The volume of non-fuel imports has been drifting downward from a peak reached in the first quarter of 1973. A further significant decline of about 14 per cent is projected during the four quarters to mid-1975, with renewed import expansion beginning only in 1976. Fuel imports are expected to stabilize in volume and value during 1975 at about the level reached late this year. Even if some new effective conservation measures are imposed, it seems rather unlikely that oil imports can actually be reduced as the economy begins to recover.

The net effect of the foregoing considerations is that the U.S. trade deficit is projected to increase somewhat further in 1975, and that by early 1976 the deficit on goods and services may be running at about a $6 to $9 billion annual rate. This would imply a current account deficit of the order of $10 to $13 billion a year. Such a deficit would represent only a moderate share of the $40 billion current deficit expected for all OECD countries combined.

So far in 1974, net capital flows into the United States have matched our widening current account deficit without much net change in the effective exchange rate for the dollar. The weighted average value of the U.S. dollar in terms of 10 leading foreign currencies is now about the same as it was just after the second devaluation early in 1973, although there have been large fluctuations.

It seems likely that direct capital inflows from OPEC countries will increase further next year from the recent rate of over $1 billion a month, and that net private outflows may be small. Hence net inflows could well continue to cover the growing current account deficit without much change in the exchange rate. Indeed, there could be a tendency for even larger capital inflows, and for some upward pressure on the exchange value of the dollar.

In summary, the United States does not seem to face much difficulty in financing its large deficit on current account. The international questions that loom largest now are (a) how deep and extended the world-wide slump in economic activity will prove to be, (b) how can countries manage the recovery while minimizing the risks of renewed inflation, and (c) how can balance-of-payments adjustments and financing for other countries be smoothly and cooperatively achieved.

Mr. Pierce made the following comments on the staff projections of U.S. economic activity:

As for the policy assumptions underlying the staff's projection, Federal budget outlays are assumed to be $307 billion for fiscal 1975 and $339 billion for fiscal 1976. No new fiscal stimulants are assumed, but we continue to incorporate expanded programs for unemployment insurance and public service employment. In addition, our spending estimates do assume some slippage in the Administration's announced budgetary goals.

As for monetary policy, M_1 growth in the first half of 1975 is assumed to make up the shortfall since last summer--returning thereafter to a 5-3/4 per cent path from mid-1975 through the remainder of the projection period.

The policy stance implied by these assumptions is fairly restrictive. Even giving full allowance for its measurement and conceptual problems, the high employment budget surplus would rise substantially further. Conditions in financial markets would ease with declining economic activity and gradual improvement in price performance, but would be firming again when economic activity begins to turn up.

We believe real GNP is falling sharply in the current quarter, and a continued decline is in prospect during the first half of 1975. By the second quarter of next year, real GNP is projected to be 3.9 per cent below the second quarter 1974 level--as large a decline as in any postwar recession. Measured from the fourth quarter of 1973, the over-all projected drop is 6.0 per cent.

This is a steep recession, but there is some basis for expecting an upturn in real output beginning in the latter part of 1975. In the absence of more stimulative policy action, however, we believe that growth in real output will remain below the nation's long-term potential growth, and will be well short of the rates characteristic of most postwar recoveries.

The course of inventory investment seems likely to be a major source of weakness over the next two quarters. There is evidence of sizable unintended inventory accumulation in the current quarter, as sales--particularly of autos, appliances and other consumer durables--have fallen sharply, and are substantially below production levels. At least a brief period of outright inventory liquidation now seems probable. But, if final sales begin to pick up in real terms, as we are projecting, a return to moderate rates of accumulation may occur by early 1976. This would be consistent with some improvement in the level of stocks relative to sales beginning around the middle of next year.

A principal source of the expected turnaround in final sales would come from residential construction. Housing starts are projected to hit a trough this winter, and then to begin a slow recovery, reflecting the improvement in savings flows and mortgage credit conditions already under way. We expect a moderate further decline in short-term interest rates in the first half of 1975, and thus some additional pickup in savings inflows to nonbank intermediaries.

As economic activity recovers later on, however, interest rates are projected to begin rising again, because growth in nominal GNP is projected to exceed substantially the rate of increase assumed for M_1. Savings inflows, therefore, fall off again and housing starts flatten out at a level far below their earlier peak.

Additional firming in final sales around the middle of next year is expected to come from personal consumption. Consumption has been affected adversely for some time by declines in real disposable income. And because of rising unemployment, a further drop in real purchasing power of consumers is projected for the first half of 1975. Thereafter, several factors--including a slower rate of inflation, a July 1 cost-of-living increase in social security benefits, and a leveling off and then modest increase in employment--will contribute to some improvement in real disposable income, and hopefully to a strengthening in consumer markets. The modest character of the projected pickup in consumer spending can perhaps best be illustrated by reference to auto sales. With the modest recovery expected for real disposable income, and with unemployment continuing high, we would project a return of new car sales to about a 10 million annual rate by mid-1976--roughly the rate of sales for the first half of 1974, when the energy crisis was depressing auto demand.

How vigorous an economic recovery we can realistically expect later next year and on into 1976 probably will depend most importantly, however, on the course of business fixed investment. Until recently, this sector has served as an important support for the economy. Outlays for fixed investment in 1958 dollars are, however, falling significantly in the current quarter, due partly to a steep decline in fleet car and truck sales. With rates of capacity utilization falling, even for major material producers, with corporate profits also under pressure, and with business expectations worsening rapidly, real outlays for business fixed investment seem likely to decline through all of 1975. Heavy investment by major material producers will, we believe, act to limit the extent of decline. But, we see no reason for expecting any recovery in real business fixed investment, given the very modest increases expected for consumer spending.

Our staff GNP projection implies substantial weakness in labor markets. Employment is projected to decline sharply over the first half of next year and to show relatively little strength thereafter. Even though labor force growth is projected to be quite slow, the unemployment rate would rise sharply in the first half of next year--to about 7-3/4 per cent by the middle of 1975--and then drift up more slowly to around 8-1/4 per cent by mid-1976. This estimate takes into account the effects of the assumed public service employment program, which reduces the unemployment rate by about three-tenths of a point.

Growing slack in both labor and product markets should improve the outlook for wages and prices. In response to high and rising unemployment rates, the rate of increase in compensation per manhour is expected to slow moderately over the projection period. Productivity should also improve once real output turns up again, so that the rise in unit labor costs is expected to drop off to around a 5 per cent annual rate by the middle of 1976.

We expect marked improvement in price performance to begin showing up in the fixed-weighted index for private product in the first half of next year, even though retail food prices may still be rising substantially. Optimism with regard to prices of nonfood commodities is warranted, we believe, by the recent behavior of wholesale prices, and by the intensely competitive conditions now prevailing in consumer markets. Further progress on the price front is probable as the year progresses, particularly if food output increases as expected. By the middle of 1976, we project that the rise in the fixed-weighted index will have slowed to an annual rate of about 5-1/2 per cent--about the same rate of increase as for unit labor costs.

In summary, the staff now expects a rather steep recession followed by a weak recovery that leaves unemployment drifting upward through mid-1976. Substantial progress is expected, however, in reducing the rate of inflation to a figure which, though high by historical standards, would represent an enormous improvement over the recent past.

Mr. Partee made the following concluding remarks:

The staff has had to adjust its projections as the downturn in economic activity has gathered momentum this fall. We first presented estimates for all of 1975 in August--estimates which, at that time, seemed on the pessimistic side. However, the near-term decline in activity, as measured by real GNP, is now expected to be substantially deeper, and the rise in unemployment much larger, with the rate escalating rapidly to about 8 per cent by next summer. Despite the extent of this writedown, however, I do not believe that we are exaggerating the weakness in the outlook. The country now is clearly in the midst of a cumulating recession, and there appears to be some distance to go before a turnaround can reasonably be expected. Indeed, our projection still does not allow for a very substantial over-all inventory liquidation, or for a sizable drop in capital spending, or for the effects of possible major difficulties in financial markets at home and abroad.

As in our August projection, we still anticipate some upturn, albeit from a much lower level of activity, beginning in the second half of 1975. But there is no basis at present for projecting a vigorous recovery, in the absence of new stimulative actions in either the fiscal or monetary area. In the four quarters from mid-1975 to mid-1976, we now anticipate an increase in real GNP of only about 2-1/2 per cent; this would mean further increases in the unemployment rate throughout the projection period.

The basis for the projected upturn lies in possible favorable developments in three sectors--inventories, consumer spending, and housing. In the case of inventories and consumer spending, we could easily find that events not allowed for in our projection could impair or delay the chances for a turnaround. For example, if real business fixed investment spending turns out to be significantly weaker than the moderate decline we have projected--more, say, like that of 1957-58--retrenchment in the desired inventories of capital goods producers and loss of jobs in that sector would work to delay recovery in aggregate inventory investment and in real consumption expenditures.

The projected upturn in housing rests, I believe, on somewhat more solid ground, since any additional weakness in other sectors would help to ease the mortgage market further and strengthen the financial basis for a housing recovery. Nevertheless, the rise in projected housing starts is far less than normal, partly because of the demoralized state of the multi-family residential market and partly because we do not expect the recent improvement in savings inflows to persist beyond the second quarter of next year, given the present assumptions as to the pace of monetary growth.

The difficulty is that the projected turnaround in real GNP, combined with moderating but still substantial inflation, will boost the rise in nominal GNP abruptly beginning in the second half of 1975. The projected growth rate of about 9 per cent in nominal GNP would be far in excess of the assumed growth in money, implying significant upward pressure on market interest rates and a consequent dampening of savings inflows to the thrift institutions. At the same time, private credit expansion would be tending to accelerate, reflecting mainly a pickup in mortgage borrowing but also continued substantial growth in business credit. And Federal borrowing needs, because of the decline in revenues associated with the recession, will be mounting rapidly.

Putting all of these considerations together, our flow of funds projection indicates that there will be only a relatively brief drop in the total volume of funds raised during the current quarter and the first two quarters of 1975, followed by a sizable rebound in the second half of 1975 and on into 1976. This implies sizable household purchases of securities again, beginning in the second half of next year, in order to balance supplies and demands in the credit markets. Such purchases are indicated to be less than in the recent tight money period, but they still are large enough to require attractive terms on the part of issuers.

Thus, the need to place securities with individuals and the shortfall of money growth relative to projected nominal GNP both suggest that interest rates will be rising again in the second half of next year. Our estimate is that the commercial paper rate is likely to increase to about 9 per cent by year-end 1975 and to 10 per cent by mid-1976--historically high levels, particularly in the context of soft product markets and a declining rate of inflation--and that long-term rates also will be turning upward. It should be noted also that we do not expect any appreciable easing of long-term rates in the interim, because new corporate offerings in the capital markets are projected to remain exceptionally large.

In view of the extreme weakness of the economy that is in prospect over coming months, it seems highly probable that the Administration and Congress will opt for more fiscal stimulus than is assumed in our basic projection. We have tried to estimate how the economy might respond to a more stimulative fiscal posture, with no change in monetary policy. The additional stimulus assumed includes a sizable boost in expenditures, a 5 per cent cut in personal tax rates, and a larger investment tax credit--the total package adding up to about $20 billion by early 1976.

We would expect such a program to add measurably to the expansion in real GNP, beginning in the second quarter of next year. The rise in the unemployment rate consequently is reduced by several tenths of a point, though it still reaches almost 8 per cent by the end of the projection period. On the other hand, the improvement in price performance would probably be somewhat less favorable than in the basic projection.

We believe, however, that the effects of the additional stimulus on real activity, in the absence of accommodative shifts in monetary policy, would rather quickly run out of steam. This is because the more expansive fiscal policy requires additional deficit financing, thus putting credit markets under increased pressure. Hence, interest rates rise more than otherwise would be the case, savings inflows to the institutions are further curtailed, the market value of existing financial asset holdings is eroded, and private expenditures for housing and for other purposes are discouraged. Because of these counter-productive effects, stronger fiscal stimulus would not be expected to provide a lasting substitute for greater monetary ease under current circumstances, but rather would require the support of a more liberal supply of money and credit.

Our second policy alternative, therefore, adds to the program of fiscal stimulus with a more expansive monetary policy, as indexed by M_1 growth on a 7-1/4 per cent path, but forgiving past shortfalls. Real GNP growth is considerably increased, and would be expected to exceed the economy's long-run 4 per cent growth potential through most of the projection period. As a result of stronger economic expansion, the unemployment rate tilts downward late next year, though the level is still projected to be about 7-1/4 per cent in the second quarter of 1976, after a full year of recovery. The improvement in the inflation rate is also distinctly less than in the base projection, however, with the increase in the fixed-weight deflator moderating to about a 6-1/2 per cent rate in the first half of 1976.

As I have said in previous meetings, the Committee is faced with extremely difficult choices in formulating its policies at the present time. These alternative projections provide additional evidence as to the substance of the trade-off problem. We believe that the combination of fiscal stimulus and a somewhat more expansive monetary policy, beginning now, would produce a markedly more robust economic upturn after mid-1975, though we think that it would still fall far short of a boom. Given the current weakness of the economy, and the very substantial continuing underutilization of resources that we foresee under even the most favorable projection alternative presented, this seems a highly desirable outcome. But the cost is that the inflation rate would be expected to show appreciably less improvement than might otherwise be achieved, and that cost would remain with us well beyond the time period of this projection.

The choice is one of policy. But the Committee should recognize that the decisions it makes now, given the lags in policy impact, will importantly influence both the probabilities that the economy will in fact turn up again about mid-year, as we have projected, and the shape that the recovery takes. Further, the Committee needs to be aware that it is apt to face a very difficult problem once economic recovery commences; a policy posture indexed by long-term growth in M_1 at anything like the 5-3/4 per cent pace currently sought, even given our comparatively optimistic outlook as to the course of inflation, is likely to bring a fairly prompt upturn in interest rates. That resurgence in rates would occur even though the economy remains far below optimum levels, and at a time when unemployment is still likely to be at 7-1/2 per cent or above.

Mr. Black referred to Mr. Partee's comments about the consequences of the second policy alternative, involving a 7-1/4 per cent growth rate in the money supply as well as more fiscal stimulus. He asked when that growth rate was assumed to begin.

Mr. Partee replied that the 7-1/4 per cent growth rate in M_1 was assumed to start at the beginning of 1975. The growth rate was taken as constant, with no attempt to compensate for the shortfall in growth during the summer and fall of 1974.

In reply to a question by Mr. Balles, Mr. Partee said the 7-1/4 per cent rate was assumed to continue throughout the projection period--that is, through mid-1976. Given the limited extent of the recovery projected for that period, it seemed unlikely that an interim change would appear desirable. Of course, if the Committee adopted such a target rate now it would in fact have many opportunities before mid-1976 to modify the target in light of the actual progress of the recovery.

Mr. Black observed that one possible course for policy would be to raise the rate of growth of the money supply now with the expectation of reducing it--perhaps to the present longer-run target rate of 5-3/4 per cent--at a later time, when the economy was recovering. He asked about the likely consequences of such a course.

Mr. Partee replied that he also had reflected on that possibility. He would expect interest rates to rise sharply at the time money growth was slowed, whatever stage the recovery had reached at that point. In his judgment, it would be extremely difficult to tolerate such a rate advance if it came at a time when unemployment was still high and resource utilization generally was well below optimal levels. He thought the recovery would have to be well advanced before the Committee would be prepared to contemplate a significant slowing in the growth rate of money.

Mr. Black noted that the lags in the effects of monetary policy usually were much longer for prices than for production and employment. Presumably, one cost of a temporary acceleration in the rate of money growth would be a higher rate of inflation 2 or 3 years from now. The important question, however, was how much higher? He asked whether the staff had any views on that point.

In response, Mr. Gramley observed that the magnitude of the effect was suggested by the projected impact on prices of the two policy alternatives Mr. Partee had described. According to the Board's econometric model, the more stimulative fiscal policy would add about one-half of a percentage point to the rate of inflation in the middle of 1976. If the more expansive monetary policy also was followed, the rate of inflation would be a full percentage point higher. Even with both types of stimulus, however, there would be continuing improvement in the performance of prices throughout the projection period. That was because, even at the end of the period, the rate of unemployment would still be in the 7-1/2 per cent area and a sizable gap between potential and actual output would remain.

Chairman Burns asked whether the staff had experimented with projections based on assumptions about the rate of growth in M_2 rather than M_1.

Mr. Gramley replied that projections had not been made on that basis, although that would, of course, be feasible. The procedure actually employed was to assume a specific growth rate for M_1 and to permit the model to determine market interest rates. The differential between market rates and the rate of return on savings deposits then determined the volume of savings flows to banks and, therefore, the rate of growth of M_2.

Mr. Partee observed that the definition of M_1 presumably would have to be modified if there were a significant trend toward extending checking privileges to savings accounts at banks or other thrift institutions. No such modification had as yet been made.

In response to questions from Mr. Mitchell, Mr. Pierce said the Board's econometric model would yield a higher rate of inflation than shown by the judgmental projection presented today. However, he would tend to agree with the judgmental forecast. In that projection, the primary reason for the expected slowing of the inflation rate was rising unemployment. It was anticipated that the rate of increase in food prices would be less than the Department of Agriculture seemed to be expecting, but still relatively rapid--about 10 per cent or more. However, the rate of increase in wages was expected to decelerate sufficiently to permit a substantial slowing of the rise in most non-food commodity prices.

Mr. Mitchell asked about the staff's assessment of a view expressed at the meeting last week of the Board and its economic consultants, to the effect that the recent increases in prices of oil and foods were one-time events which had led to unavoidable increases in the general price level but which had no necessary implications for the subsequent rate of inflation.

In reply, Mr. Pierce remarked that an exogenous change in prices was not necessarily a "once and for all" event because it could affect the rate of advance of wages, and that in turn would have implications for the future course of prices. Ultimately, however, the rate of inflation depended on the long-run course of monetary policy. Thus, while the level of prices might inevitably be raised by an exogenous increase in the price of oil or other commodities, the subsequent rate of inflation could eventually be controlled.

Mr. Gramley added that the staff's assumptions about the nature of wage settlements did not differ radically from those mentioned at the meeting with the economic consultants. Even though quite large settlements were expected in major collective bargaining agreements, it was anticipated that there would be significant slowing in the rate of wage advance in the more competitive sectors of the economy. Furthermore, as the rate of increase in consumer prices slowed, the size of the cost of living increases under escalator clauses would decline. Over all, the rise in average compensation per manhour was projected to slow to an annual rate of about 7-1/2 per cent by mid-1976. That seemed to be a reasonable expectation in light of the projected high level of unemployment.

Mr. Mitchell then noted that in the staff presentation a good deal of emphasis had been placed on the rate of growth of real money balances. He asked if the staff believed that the Committee should focus on the real rather than the nominal supply of money.

Mr. Gramley said he would not recommend that the Committee set its targets in terms of the real money stock; to do so could be dangerous. However, he thought the Committee should give careful attention to changes in real money balances. The economy had experienced price increases that were largely a consequence not of current policy decisions but of such factors as excess demand in past periods, increases in oil and food prices, and the removal of price controls. In the context of such price rises, the Federal Reserve had maintained a relatively slow rate of growth in nominal money, and real balances had declined by about 8 per cent from their peak level. That was bound to have a serious effect on the economy.

Mr. Partee added that the staff would suggest that in setting its targets for growth in the nominal money stock the Committee take account of the changes that had occurred in the real balances; in effect, it should modify its targets for the nominal money stock in light of the changes in the real stock.

In response to questions by Chairman Burns, Mr. Partee said the tax cuts provided for in the policy alternative were assumed to go into effect as of the beginning of 1975. The assumptions made in connection with the investment tax credit included an increase in the credit from 7 to 10 per cent and changes in the investment tax rules somewhat more liberal than those worked out by the Treasury in connection with the Presidential message of October 8; in particular, it was assumed that the depreciation deductions would not be eliminated, as called for under the Administration's proposal. The modifications of the investment tax credit were taken to be a one-time, permanent change. The 5 per cent reduction in personal income taxes also had been treated as a permanent change, because much of the effect of a tax cut announced as temporary would be reflected in a rise in savings rather than in spending. That did not mean, of course, that taxes could not be raised again later.

The Chairman then asked what the staff thought the net effect would be of a simultaneous decrease of, say, $20 billion in both Federal expenditures and business taxes.

In response, Mr. Pierce said the econometric model would indicate that such a policy was deflationary, on balance, because it would result in a rise in savings. He thought the net effect would not be large, although the precise outcome would depend on which business taxes were reduced.

Mr. Partee remarked that if he were considering such policy actions in connection with a judgmental projection he would come to the same conclusion. A cut in the corporate income tax rate, for example, was likely to be reflected in some rise in _ex ante_ savings, in either the corporate or the personal sector, so that the increase in private spending would be smaller than the reduction in Federal spending. If, however, the action with respect to business taxes was a kind that greatly increased investment incentives, it was possible that the effects of the reduction in Federal spending would be offset.

Chairman Burns observed that in his opinion the effects would be strongly expansionary rather than deflationary; a $20 billion tax cut would create a wholly new environment for business enterprise, and businessmen would react by putting their brains, their resources, and their credit facilities to work. His disagreement with the staff on that point reflected a basic difference in interpretation of how the economy functioned and how fiscal stimulants and deterrents worked their way through the system.

Mr. Sheehan noted that at the Committee's September meeting Mr. Gramley had expressed the view that if the rather bleak economic projection presented then was in error, the error probably was in the direction of underestimating the downward adjustment that lay ahead. He wondered whether the staff thought the gloomy projection presented today was likely to prove to have erred on the optimistic side.

Mr. Gramley replied that, while the projection represented the staff's estimate of the most likely outcome, he still thought that any errors were likely to be in the direction of optimism. He might note in particular that the projection called for a decline of 9 per cent in real fixed investment by business from the third quarter of 1974 to the second quarter of 1976. Business investment had dropped 16 per cent during the 1957-58 recession, and it was not inconceivable that a decline of that magnitude would occur in this recession.

Mr. Partee said his instincts suggested that economic activity would be somewhat weaker than projected. He noted, however, that economists often were unduly bearish because of the difficulty of anticipating where sources of strength would develop. He might note also that the basic projection did not allow for fiscal stimulus, aside from the expected rise in budget expenditures to $307 billion in fiscal 1975. It was highly probable that fiscal policy would be more stimulative than assumed, and that that would tend to shift the actual outcome in the direction of a less steep decline and a less protracted period of weakness than indicated by the projection.

Mr. Hayes asked what the staff thought the effect on interest rates might be if the Federal deficit were financed largely by inflows of funds from the OPEC countries.

Mr. Partee replied that there was not likely to be much effect on the general level of interest rates because the funds would simply be transferred from other investors to OPEC investors. However, since the OPEC investors were more likely to purchase Government securities than other investors were, there might well be more downward pressure on yields of Governments and upward pressure on rates in other credit markets, such as the mortgage market. Also, the exchange rate for the dollar might be strengthened if the inflows were large and the funds were not reloaned abroad.

Mr. Reynolds noted that the staff estimated that inflows of OPEC funds would be roughly $16 to $18 billion in 1975, of which perhaps two-thirds would be invested in U.S. Government securities.

Mr. Hayes then observed that he found the staff projection of deterioration in the trade balance puzzling. Given the weakness in the domestic economy, it seemed likely to him that U.S. imports would weaken relative to exports.

Mr. Reynolds noted that there was, naturally, considerable uncertainty attached to a projection of the trade balance as far out as mid-1976, and it would be surprising if the forecast were accurate within a margin of $3 or $4 billion. The trade balance was projected to deteriorate through most of the projection period because it was usual for U.S. imports of materials and consumer goods to turn up rather quickly at the beginning of a recovery in the domestic economy, whereas there ordinarily was a much longer lag between an economic upturn in foreign countries and a rise in U.S. exports. That lag was long because foreign industries tended to utilize the domestic capacity that had been idled during the recession before increasing purchases of industrial materials and capital equipment from the United States. If the projection were to be extended beyond mid-1976, it probably would begin to show an improvement in the U.S. balance of trade.

Mr. Francis noted that according to the staff's basic projection, which assumed a 5-3/4 per cent growth rate in M_1, interest rates would turn up in the latter part of 1975 but would not return to the recent peak levels at any time during the projection period. If, however, the Committee were to adopt a longer-run target for M_1 of 7-1/4 per cent, which the staff had presented as a policy alternative, he wondered whether interest rates would not ultimately rise to levels above the recent peaks.

In response, Mr. Partee remarked that one reason the staff did not anticipate a return to recent interest rate peaks during the projection period was that it did not expect the economy to be subjected during that period to the severe stresses experienced in the past year and a half. As had been suggested earlier, if the Committee adopted a 7-1/4 per cent growth rate target, it would be desirable to reduce the target at some juncture after the level of resource utilization had increased. The point he had tried to make was that it probably would not be feasible to reduce the target as long as unemployment was still very high; the reduction would have to be made carefully and gradually, as the rate of unemployment declined. He thought it would be possible, by use of the Board's econometric model, to develop a strategy for policy that would ultimately result in both a lower steady-state rate of inflation and a higher level of resource utilization than that estimated for the projection period. However, that outcome probably could not be achieved until well beyond mid-1976.

Mr. Mayo observed that one way of attaining an average rate of growth in M_1 of 7-1/4 per cent for some temporary period would be to start out with faster growth--at a rate, say, of 8-1/2 per cent--and then gradually reduce the rate. He asked whether the staff thought such a course would improve the chances of getting back to a 6 per cent growth rate without untoward effects.

In response, Mr. Partee remarked that an earlier injection of money, such as suggested by Mr. Mayo, would speed up the recovery, so that the level of resource utilization might be higher than otherwise at the time the 6 per cent growth rate in money was restored. However, a rate of growth in the money supply as high as 8-1/2 per cent for more than a month or two would be likely to exacerbate market expectations of inflation. A growth rate of 7-1/4 per cent was within the range of recent experience and therefore probably would not have that effect.

Mr. Mayo concurred in Mr. Partee's observation about the probable consequences of an 8-1/2 per cent growth rate in the money supply. He added that, because such a growth rate probably would lead observers to believe that the System had given up the fight against inflation, longer-term interest rates might begin to back up immediately.

In reply to a question by Chairman Burns, Mr. Partee remarked that the staff had not assumed that wage and price controls would be reimposed.

The Chairman then observed that, historically, upturns in the wholesale price index and in economic activity had tended to be roughly coincident. In the staff projection, however, the rate of increase in the price level--as measured by the fixed-weighted GNP deflator--continued to decline throughout the projection period, although economic activity began to recover after mid-1975. He asked whether that was because the deflator was dominated by consumer rather than by wholesale prices.

Mr. Partee said that was the principal explanation. Wholesale prices of sensitive materials were likely to be much weaker than the deflator during the next 6 months, and if the recovery was slow--with substantial unemployment and unused industrial capacity--the behavior of such prices could remain rather favorable. It was his recollection that, following the 1960-61 recession, the wholesale industrial price index did not increase noticeably until the latter part of 1964, after the recovery had been under way for several years. Sensitive raw materials prices began to turn up in the fall of 1963.

In response to a further question by the Chairman, Mr. Gramley observed that the projected upturn in corporate profits--to nearly the third-quarter 1974 level by mid-1976--appeared rather large in view of the weakness of the projected recovery in activity. Those profits figures suggested that the rather optimistic price projections were not unjustified, if the assumption that the rate of increase in compensation per manhour would slow to 7-1/2 per cent by the end of the projection period was correct. That was because a faster price advance than projected would result in an even larger increase in corporate profits, and that would seem unlikely given the projected degree of slack in the economy.

Mr. Wallich commented that the projected level of profits after inventory valuation adjustment would represent only about 6 per cent of GNP, which was not particularly high for a recovery period.

Mr. Partee said that was true for recoveries in general. As Mr. Gramley had suggested, however, the staff was concerned that the profits projection might be too high for the type of recovery anticipated. Accordingly, it had examined the figures thoroughly before presenting them.

Mr. Partee added that he shared Mr. Gramley's view that the price projection might seem to be on the optimistic side. He personally would have hesitated to present such a projection had it not been for the test of reasonableness offered by the profits projection.

In reply to a question by Mr. Coldwell, Mr. Gramley said the labor force was expected to increase quite slowly during the projection period--by about 700,000 persons between the fourth quarters of 1974 and 1975, and by 900,000 persons between the second quarters of 1975 and 1976, when the recovery was expected to be under way. The normal increase was roughly 1.5 or 1.6 million. It was anticipated that high unemployment rates would tend to discourage workers from entering the labor force.

Mr. Partee added that there had been little evidence of the "discouraged worker" effect until very recently, and over the last year or so the increase in the labor force had been larger than normal. If it turned out that the "discouraged worker" effect was offset by the encouragement to labor force participation caused by the impact of inflation on family budgets, the projected unemployment rate would, of course, prove to be too low.

Mr. Coldwell noted that the economies of most industrial countries seemed to be in roughly the same phase of the cycle currently. He asked about the implications of that fact for U.S. monetary policy.

In reply, Mr. Partee observed that some foreign nations had already undertaken expansionary economic policies and others were expected to follow suit. Thus, if the United States adopted more stimulative domestic policies it would not be far out of step with most other industrial countries. There was a possibility, in an environment of slack markets all over the world, that foreign business firms would be more alert than U.S. firms to opportunities for increasing exports. In that event, net exports would deteriorate by more than the rather moderate amount the projections suggested.

In response to a further question by Mr. Coldwell, Mr. Gramley observed that the declines in production and employment thus far in the current recession were about as rapid as in any other postwar recession.

Mr. Wallich asked about the methods the staff used in projecting interest rates. In that connection, he noted that both long-term and short-term rates were projected to be in the neighborhood of 10 per cent in mid-1976 and that the rate of inflation was projected to moderate to about 6 per cent at that time. The implication was that real interest rates would rise from current--in some cases, negative--figures to a level of about 4 per cent. It seemed to him that there would be more downward pressure on interest rates than the projection implied. For one thing, the slowing in the rate of inflation should influence investor expectations. Furthermore, as Mr. Hayes had mentioned earlier, OPEC investors would be placing funds in the United States. While it was true that such placements would not involve a net inflow of funds, the change in ownership of the funds--from oil consumers to the OPEC countries--should result in some shift away from consumption and towards investment.

Mr. Partee observed that the staff used various kinds of information in projecting interest rates. Among other things, it considered the relationship between money supply and nominal GNP;

the results of the Board's econometric model simulations, which allowed for inflation premiums; and flow-of-funds projections, which made possible sectoral analyses. For example, the flow-of-funds data suggested that the current problems in the municipal bond market would continue through mid-1975 and that corporate bond offerings would remain heavy throughout the year, both of which implied that households would have to be heavy purchasers of securities. While he would not place great confidence in any specific numerical projection of interest rates, he did expect the general level of rates to rise, given the magnitude of the projected increase in nominal GNP.

Mr. Gramley said he agreed with Mr. Partee's observations. He also agreed with Mr. Wallich's view that the real interest rates projected appeared to be high, assuming declining inflationary expectations. If businessmen came to believe that the rate of inflation would moderate substantially, interest rates would have to decline considerably or business fixed investment might be weaker than projected.

Mr. Eastburn observed that productivity typically began to increase in the recovery phase of the cycle. In recent conversations with businessmen in the Third District, however, it had been reported that productivity was increasing markedly now. He asked about the staff's assumptions regarding the likely trend.

Mr. Partee noted that productivity had declined sharply thus far in 1974. The projection called for progressively smaller declines through mid-1975 and progressively larger increases thereafter. The rate of improvement shown was less rapid than that in the econometric projection. However, it was more rapid than historical experience would suggest; typically, gains in productivity had remained small until there was a substantial acceleration in economic activity.

Mr. Zeisel added that it was unusually difficult to assess the likely course of productivity at this time. The recent sharp deterioration suggested that manhours worked had not yet been adjusted downward sufficiently. On the other hand, if real output were to decline further in the first half of 1975 at the rate projected, a significant improvement in productivity would involve a decline in employment deeper than seemed realistic.

Chairman Burns expressed the view that a rapid increase in productivity would result in a dramatic improvement in business expectations and an upgrading in business spending plans.

Mr. Eastburn then noted that in the discussions he had mentioned, Third District businessmen had evidenced great concern about the real estate situation, especially the plight of REIT's. He wondered what assumptions the staff had made about the outlook for REIT's and the steps the Government might take to ameliorate the situation.

Mr. Partee replied that, while some REIT's or construction firms might fail, the staff had not assumed a financial collapse in the real estate industry that would seriously affect the banking system, and therefore no Government programs to assist REIT's had been allowed for in the projection. There was, of course, a possibility of severe shocks to the financial system from serious difficulties in the real estate industry or failures of major corporations here or abroad. However, it was impossible to predict such situations or to estimate the effects they might have on real output.

Mr. Holland asked what the implications would be for the staff projection if it were assumed that interest rates would not rise in the second half of 1975. He might note two possible situations in which interest rates would remain stable. First, there might be a change in the attitudes of private investors--resulting from a moderation in the rate of inflation--that would induce them to participate in mortgage markets, for example, without any rise in interest rates. Second, in mid-1975 the Federal Reserve System might become sufficiently satisfied with the moderation in inflation and the increase in productivity to pursue a monetary policy that would keep interest rates stable.

In response, Mr. Partee said he thought the outcomes in the two situations would be different. In the first case he would expect the shape of the yield curve to change; it would become more downward sloping as investors, no longer fearing renewed inflation and higher interest rates in the future, became willing to buy relatively more long-term securities. Such a development would lower real long-term rates of interest and would encourage investment in business fixed capital and in housing. In the second case, he would expect the whole term structure of rates to be lower than otherwise. Since that would improve credit availability generally, it would have more favorable implications for output than the first case.

Mr. Gramley remarked that the terms in which Mr. Holland had described the first case referred only to the attitudes of lenders; in his judgment, it was necessary to consider borrowers' attitudes as well. As Mr. Partee had suggested, a shift in the preferences of lenders from short-term to long-term assets would tend to lower long-term rates. However, if rates did not decline fast enough to keep pace with the abatement of inflationary expectations of borrowers, there might be little positive stimulus to investment. Unless there also was some assistance in the form of an accommodative monetary policy, the outcome was as likely to be negative as positive.

Mr. Partee added that the decline in long-term interest rates to which he had referred would, in effect, be offset by an increase in short-term rates if the preferences of borrowers shifted to short-term debt because they expected further declines in long-term rates.

Mr. Holland then hypothesized a situation in which the inflationary expectations of both lenders and borrowers abated at about the same rate, resulting in a level of nominal interest rates significantly lower than projected and in stability in real rates of interest. He asked if expenditures on housing and business investment would be stimulated by such developments.

Mr. Gramley expressed the view that if real interest rates did not change, a decline in nominal rates would not in itself result in an increase in investment. The decline in nominal rates might, of course, be associated with other developments--such as an improvement in the availability of mortgage credit--that would encourage spending.

Mr. Partee remarked that a decline in nominal interest rates by itself could result in some marginal improvement in housing demands, insofar as home buyers probably were less sensitively attuned than other investors to the role of inflation in affecting the real costs of particular interest rates.

Mr. MacLaury noted that the staff's projection of an upturn in the latter half of 1975 was based on an expectation of favorable developments in three sectors--inventories, consumer expenditures, and housing. He wondered about the extent to which the spending increases were predicated on an assumed improvement in the stock market.

Mr. Pierce replied that some improvement in the stock market was assumed in the econometric projection, and the resulting wealth effect had some impact on consumption spending. However, the consumption figures so obtained were surprisingly close to those shown in the judgmental projection, in which the increase in real consumption reflected an improvement in real disposable income. Thus, the stock market did not appear to be a major factor.

Mr. MacLaury then noted that the availability of mortgage credit and the level of mortgage interest rates ordinarily were taken to be the main determinants of the demand for housing. He wondered whether it was not also important to consider the rise in the cost of housing relative to consumer real income.

In response, Mr. Pierce observed that in the staff projection consumer incomes rose more rapidly than prices after mid-1975; that was one factor in the expected increase in housing expenditures. Thus, the real income constraint was projected to become less important in holding down the demand for housing. The relatively low level of real interest rates also should encourage housing demand. He would emphasize, however, that the projected improvement in housing starts was rather weak in comparison with the rapid expansion typical of previous housing cycles.

Mr. Partee added that there was likely to be some delay in the upturn in multifamily housing--which had been an important factor in the recovery phases of recent housing cycles--as a result of the attitudes of both builders and lenders and of the volume of unsold units. Moreover, the improvement in inflows to thrift institutions was not projected to continue beyond mid-1975, and there was no reason to believe that mortgage lenders would liberalize terms substantially. Since the price of housing had become an increasingly important consideration to buyers in recent years, easy credit terms were likely to be more necessary than usual to encourage an upswing in housing.

The Chairman remarked that he would describe the recovery in housing projected for 1975 as quite vigorous. However, the rise was shown as tapering off in 1976.

Mr. Kimbrel asked if the staff believed that the legislation permitting U.S. citizens to buy gold would have a significant impact on the rate of growth of the money supply.

Mr. Partee said he thought that legislation would have little or no effect on the demand for money. Most gold purchases were likely to be made with funds shifted out of interest-bearing balances or the securities markets.

Mr. Reynolds added that the projection of net exports allowed for an increase of about $1 billion in gold imports in 1975. Any such projection was, of course, subject to a great deal of uncertainty.

Mr. Winn noted that the projection necessarily took no account of such unpredictable factors as major financial shocks, war in the Middle East, and new approaches to the energy problem or other changes in Administration policy, except insofar as they affected the budget estimates. He wondered which of such factors the staff thought were most likely to alter the forecast significantly.

Mr. Partee said that, aside from the possibility of financial shocks, the major source of uncertainty with respect to the projection probably was the threat of war in the Middle East. An abrupt change in the psychology of businessmen or consumers also could have significant effects. The consequences of a mandatory program to reduce oil imports by, say, one million barrels a day would depend on when it was put into effect and how it was administered, but he thought it was unlikely that any such program would have a significant impact on the economy during the projection period.

Chairman Burns commented that if such a program were adopted it probably would dampen real economic activity still more and increase the rate of inflation somewhat. There were many who urged--in his opinion, correctly--that the Government should deal promptly and effectively with the energy problem, but they often overlooked the costs involved.

The Chairman then remarked that the staff had presented a cyclical analysis that did not touch on some highly important long-range problems of economic policy which were not irrelevant to monetary policy. First, for almost a decade there had been a genuine and deep depression in corporate profits. Second, during that decade there had been very little growth in productivity. Third, one of the most significant changes that had occurred in the structure of income distribution, and one of the most often overlooked, was the decline in the proportion of the national income going to workers and investors.

It was his belief, Chairman Burns continued, that the nation required economic policies that would deal with those longer-range problems and not just with problems of the cycle. It was necessary to consider what economic policies were needed--and how monetary policy could contribute--if existing trends were to be modified in such fashion that the nation would achieve the prosperity it could and should have; otherwise, the country could face stagnation in the longer run. And one of the most serious of the nation's problems--which had been recognized in today's presentation--was that of secular inflation.

Thereupon the meeting recessed until 9:30 a.m. the following morning, Tuesday, December 17, 1974. The attendance was the same as on Monday afternoon except that Mrs. Junz, Miss Morisse, Miss Pruitt, and Messrs. Annable, Beeman, Enzler, Gramley, Kichline, Parthemos, Peret, Pizer, Reynolds, Roxon, Siegman, Smith, Taylor, Truman, Wendel, Wernick, Wonnacott, and Zeisel were absent, and the following were present:

Mr. Guy, Deputy General Counsel

Ms. Tschinkel, Manager, Securities Department, Federal Reserve Bank of New York

Mrs. Farar, Economist, Division of Research and and Statistics, Board of Governors

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on November 19, 1974, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on November 19, 1974, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period November 19 through December 11, 1974, and a supplemental report covering the period December 12 through 16.

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:

> At the time of our last meeting, we were intervening in four different European currencies to check a heavy wave of speculation against the dollar. The four European central banks concerned reinforced our efforts by similar operations in their own markets, and this concerted intervention quickly brought about a sharp recovery of the dollar rate. Later in November, however, the dollar began to sag once more, largely reflecting market expectations that another big German trade surplus would be reported for October. To check an unduly sharp rate decline, we joined forces with the German Federal Bank in dollar support operations on two occasions in the latter part of November and in the process borrowed and sold a total of slightly more than $26 million worth of marks. This pushed our mark swap debt at that point up to $268 million.
>
> As our own trade figures for October showed remarkable strength, however, the dollar recovered and we were able to go into the market on the other side, buying in not only $85 million worth of marks, but also $22 million worth of Dutch guilders and $8-1/2 million worth of Belgian francs. These purchases were used to pay off entirely the Dutch guilder and Belgian franc debt we had incurred earlier in the month and to pay down our swap debt to the German Federal Bank to $185 million.
>
> Since then, the dollar has shown renewed weakness, partly reflecting the continuing decline of interest rates here in the face of steady or more slowly easing interest rates in Europe, as well as the report that Kuwait had contracted to buy $400 million worth of Daimler-Benz shares and would be in the market to buy a corresponding amount of marks to finance the purchase. Furthermore, the dollar also began to experience some pressure from

the year-end window-dressing activities of many European banks. Finally, last week we seemed to have suffered some backwash of pressure on the dollar from heavy operations by the Bank of England to check a speculative attack on sterling.

Despite these troublesome developments, the markets remained fairly orderly and we allowed the dollar to slip down gradually until yesterday, when the rate on the mark threatened to go through the 2.44 level, roughly where it was at the time of the last Committee meeting. We intervened yesterday afternoon, selling about $7.5 million worth of marks in the process, and in view of the way in which market conditions were deteriorating we suggested to the German Federal Bank that it might buy dollars at the fixing this morning. The Federal Bank did buy about $10 million at the fixing, but new selling pressures on the dollar subsequently emerged and the dollar rate has now dropped by roughly three-fourths of one per cent since last night's close.

Two reasons have been cited for the overnight weakening of the dollar. First, the price of gold rose sharply, from $183 to $190 per ounce, following the announcement in the Martinique communique that President Ford and French President Giscard d'Estaing had agreed that it would be appropriate for countries wishing to do so to value their gold holdings at current market prices. It is not entirely clear why those developments should be translated by the market into a prospective weakness of the dollar; perhaps they are viewed as the first of a series of steps that would culminate in a new realignment of parities. Secondly, Kuwait is reported to be acquiring marks to complete the financing of its purchases of Daimler-Benz shares.

It appears that the time has come again for concerted intervention to counteract the rather severe deterioration of confidence in the dollar that has occurred since yesterday. The Swiss National Bank has offered to provide the System with up to $20 million worth of Swiss francs for intervention in New York beginning at the time their markets close,

> which would be 10 a.m. here. It might also be desirable for the System to make a small drawing on its Swiss franc swap line in order to engage in supplementary operations. Intervention in guilders and Belgian francs on a small but visible scale would also be desirable, but as usual the main effort probably should be made in marks.
>
> One item that might be considered as good news is that the System has now paid off $300 million of the roughly $725 million of foreign exchange contracts of the Franklin National Bank which it had purchased from Franklin in September under a special Committee authorization. I would hope that the bulk of the remaining contracts will be disposed of by early February. So far, the net outcome in terms of profit and loss has been well within the estimated range.

In reply to a question, Mr. Coombs expressed the view that declines in U.S. interest rates relative to European rates had contributed to the recent weakness of the dollar. It was, of course, not only relative levels of interest rates that mattered, but also the size of any forward premiums or discounts on currencies. At the moment the forward premiums on marks and Swiss francs, for example, were in the neighborhood of 1-1/2 to 2 per cent, which made the interest rates available in those countries quite attractive. While the United States had been urged by various foreign statesmen to adopt policies designed to check recessionary tendencies and thus avoid precipitating a world-wide recession, he thought there was room for other countries to be more helpful in that regard than they had been.

Mr. Wallich remarked that it would be useful for the Committee to give some thought to the level of dollar exchange rates that might be desirable under current circumstances. Yesterday's presentation by the staff suggested that the condition of the real economy was worse than had been thought earlier and the outlook for inflation perhaps was not quite as bad. Presumably, domestic monetary policy would respond to that information in some manner, and he thought some response in terms of exchange rate policy might also be called for. He had no preconceived notions regarding the conclusions that should be reached.

In reply to the Chairman's request for comment, Mr. Coombs said it was his view at the moment that the dollar was still grossly undervalued. Anyone traveling in Europe today would be shocked at the prices being asked--not simply of tourists at hotels and restaurants, but for goods and services generally. The exchange rate for the Swiss franc had risen by well over 50 per cent in the past 3-1/2 years, and that for the mark was up by nearly 50 per cent. He saw no basis at the moment for presuming that the dollar was overvalued or for believing there was anything to be gained by letting dollar rates slip. To his mind, the evidence pointed to precisely the opposite conclusion; even to permit the dollar to remain at current levels for a protracted period would serve only to generate further inflationary pressures in the United States, and in due course--if a worldwide recession lay ahead--to create distortions in the pattern of world trade.

Mr. Francis said he had not been under the impression that the present level of the dollar was contributing to inflation to the extent Mr. Coombs had implied.

In response, Mr. Coombs remarked that a low value for the dollar tended to raise the cost of all imports and to give exporters an incentive to increase dollar prices. The effects were sizable, since U.S. foreign trade now amounted to approximately $200 billion per year.

Chairman Burns observed that Germany's foreign trade surplus was now running at an annual rate of about $20 billion. He asked what implications Mr. Coombs thought that might have for the mark-dollar exchange rate.

In responding, Mr. Coombs said he might first note that along with that trade surplus Germany had a large deficit on invisibles, including tourism and remittances of foreign workers. Secondly, Germany had benefited from the problems of two close trading partners, the United Kingdom and Italy; there had been a huge shift of trade in the area which accounted for an important component of the German trade surplus. Finally, he thought Germany had been enjoying a seller's market in recent years in which a rise in the exchange rate for the mark had simply added to the value of its exports. That situation could change, and German industry could very well find itself far less competitive than one might expect on the basis of the recent record. German export orders already appeared to be tailing off.

With respect to Mr. Coombs' concluding comment, the Chairman remarked that he had been hearing such statements for the last 2 or 2-1/2 years.

Mr. Coombs replied that the evidence in the recent figures was fairly distinct. In any event, he would not want to forecast Germany's foreign trade in 1975 by extrapolating the trends of, say, 1973 and 1974. He thought an inflection point had been reached, and that it would be well to await the actual figures.

Mr. Morris expressed the view that Mr. Coombs had an exaggerated impression of the domestic inflationary consequences of the foreign exchange situation. In his view, the recent weakness of the dollar had been fairly well confined to its relationship to the mark and Swiss franc; the dollar had not been weak in relation to the currencies of other major countries, with which the United States conducted the bulk of its foreign trade.

In response to a question, Mr. Bryant observed that the average value of the dollar in terms of 10 leading foreign currencies, on a trade-weighted basis, had declined by about 3 per cent in recent months, after having risen somewhat more from the 1974 low reached in May. While that measure of the dollar's value had undergone wide fluctuations in the past 2 years, perhaps the most significant point was that its current level was not greatly different from that in March 1973, just after the second devaluation. With respect to the issue of the inflationary consequences of declines in the exchange rate, he thought it was important to distinguish between rate movements that were considered likely to be transitory and those that were not. He would be much more concerned about the inflationary impact of the latter.

Chairman Burns remarked that the distinction Mr. Bryant had mentioned could be difficult to make in practice; a fluctuation that appeared to be transitory at the time often proved to have been the beginning of a long-run movement.

Mr. Coombs commented that there was a real danger of underestimating the significance of a decline in the dollar exchange rate. Taken by itself, a decline of, say, 5 per cent in a short period might not appear unduly serious. Such a movement, however, could generate forces that resulted in a much larger decline, if traders who suffered losses on their dollar holdings become disinclined to retain their dollar receipts, perhaps even overnight. Such a situation had developed on two or three occasions over the past 2 years; after an initial decline the dollar had seemed to hit an air pocket and had fallen sharply further. He would want to guard against a repetition of that pattern, particularly in the context of the more general present question concerning the direction of flows of oil revenues. With respect to Mr. Morris' observation that the recent weakness of the dollar had been mainly in relation to the mark and Swiss franc, a decline in the dollar rate against a number of key currencies could have unfortunate psychological effects on commodity markets. Since many commodity prices were quoted internationally in dollar terms, such declines could lead to speculative and inflationary reactions.

Mr. Solomon said he would like to offer a comment about Germany. While it was true that Germany was making large net payments on nontrade items, it would have a current account surplus this year of more than $10 billion, even though--like other industrial countries--it was an oil importer. Moreover, according to the best estimates the surplus would persist in 1975, although it might be smaller than in 1974. Under current circumstances, it was normal for an oil-importing country to have a deficit on current account. He thought the present disequilibrium in Germany's balance of payments was tremendous--perhaps as large in absolute terms as the disequilibrium in the U.S. payments balance had been in 1971. It was his personal view that, by one means or another, the mark would appreciate against other currencies.

Mr. Solomon added that a generalized downward movement in the dollar would, of course, raise costs in the United States. In arriving at a judgment regarding the proper rate for the dollar, however, it was important to distinguish between movements against the mark--and possibly also the Swiss franc, which was now a haven currency because of the possibility of a new Mideast war--on the one hand, and more generalized movements on the other.

Mr. Hayes said he might mention in passing that German and Swiss bankers had indicated to him in recent months that in their judgment, the dollar was substantially undervalued in terms of the mark and Swiss franc.

Mr. Coombs observed that questions about the fundamentals presumably would be resolved to some degree over the course of 1975. However, the System was faced with an immediate market situation that had nothing to do with fundamentals. The present situation had been generated to a large extent by such factors as Kuwaiti purchases of marks to finance the acquisition of Daimler-Benz shares, interest rate inducements to move funds into Germany, and public statements by German officials a month or so ago expressing no objection to an appreciation of the mark. Funds were flowing into Germany not because market participants expected some particular outcome with respect to the German trade balance in 1975 but for much more immediate reasons largely related to psychology.

Mr. Wallich remarked that he did not mean to debate with Mr. Coombs about the current situation in the market. He might note, however, that attitudes toward foreign exchange rates since they had begun to fluctuate a few years ago were similar in some respects to the attitudes toward U.S. Government bond prices around the time the peg was removed in 1951. There was great concern both before and shortly after the removal of the peg that bond prices would fall sharply and persistently and that--unless the Federal Reserve stabilized bond prices--the nation might be exposed to considerable instability in both financial markets and markets for goods and services. The concern about freely fluctuating bond prices proved to be much exaggerated, and to the extent it was not, the nation learned to live with the consequences. He would much prefer to have exchange rates remain stable; he considered stable exchange rates, in contrast to fixed bond prices, to be desirable. At present, however, he thought such stability could not be achieved. Accordingly, he would favor tolerating some movement, both up and down, in exchange rates.

Mr. Coombs remarked that that was precisely the course the Desk had been following. He thought a problem arose only when exchange rate fluctuations threatened to get out of hand.

> By unanimous vote, the System open market transactions in foreign currencies during the period November 19 through December 16, 1974, were approved, ratified, and confirmed.

Mr. Coombs noted that a System drawing of $54.6 million equivalent on the German Federal Bank would mature for the first time on January 10, 1975. There was some likelihood of a favorable movement in the mark-dollar exchange rate after the turn of the year, when year-end window dressing would subside, that would enable the System to pay off the drawing at maturity. He would assess the chances of full repayment as about even. He recommended renewal of the drawing in the event that repayment was not feasible.

Possible renewal for a further period of 3 months of the System drawing on the German Federal Bank maturing on January 10, 1975, was noted without objection.

Mr. Coombs then reported that two System swap drawings on the National Bank of Belgium, totaling $31.8 million equivalent, would mature for the fourteenth time on January 17 and 24, respectively. He had not yet heard whether the U.S. Treasury had received the expected letter from the Belgian Ministry of Finance indicating that the Belgians would not accept the Treasury's proposals regarding loss-sharing on repayments of the System's Belgian franc swap debt outstanding since 1971. In any event, he would recommend that, as a precautionary measure, the Committee approve renewal of the two drawings if necessary. Because the Belgian swap line had been in continuous use for more than one year, express authorization by the Committee was required if the drawings were to be renewed.

Mr. Holland said it appeared from Mr. Coombs' comment that not much had been done recently to expedite repayment of the Belgian franc drawings. He asked whether Mr. Coombs had held further discussions of the matter with Belgian officials during the December Basle meeting.

Mr. Coombs said he had discussed the matter with an official of the Belgian National Bank during the Basle meeting. The latter had indicated that to his knowledge there had been no change in the Ministry's position, but that he was not sure whether the Ministry's letter to the U.S. Treasury had been dispatched as yet. He (Mr. Coombs) thought it would be desirable to wait until the Treasury had received the letter before pressing the question of System repayments.

Chairman Burns asked whether Mr. Coombs could urge the Belgian authorities to expedite the letter, and Mr. Coombs said he would do so.

> By unanimous vote, renewal for further periods of 3 months of two System drawings on the National Bank of Belgium, maturing on January 17 and 24, 1975, respectively, was authorized.

Secretary's note: A report by Mr. Solomon on the November meetings of Working Party 3 and the Group of Ten Deputies, distributed to the members prior to this meeting, is appended to this memorandum as Attachment A. A report by Mr. Wallich on the December Governors' meeting in Basle, distributed during this meeting, is appended as Attachment B.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of System Open Market Account covering domestic open market operations for the period November 19 through December 11, 1974, and a supplemental report covering the period December 12 through 16. 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:

> Since the Committee last met, open market operations worked towards a steady decline in the Federal funds rate. With M_1 coming in at the lower end of the Committee's range of tolerance, nonborrowed reserves were supplied more generously and member banks reduced their borrowing at the discount windows substantially. By the close of the period, the Desk was seeking a pace of reserve supply that was expected to result in a Federal funds rate of about 8-3/4 per cent or a little below.
>
> Interest rates--particularly in the Treasury sector--declined on balance in response to the lower funds rate, the cut in the discount rate, and growing evidence of a weakening economy. Average rates of 7.06 and 6.86 per cent were established on 3- and 6-month bills, respectively, in yesterday's regular Treasury bill auction, down 47 and 57 basis points from the average set in the auction just prior to the last meeting.
>
> In anticipation of further declines in interest rates, dealers built up inventories of Governments, agencies, and other securities. Attempts to lighten inventories from time to time resulted in some congestion in the corporate and particularly the municipal market. Conditions in the latter market, in fact, neared a state of crisis as dealers were forced to take heavy losses on New York City bonds and notes in the absence of the usual demand from commercial banks and casualty companies. There has been considerable concern about the ability of New York City and some other municipalities to raise money needed early in the new year, and a series of meetings between market participants and city officials is currently under way. Tax-exempt yields reached an all-time high over the period and a number of New York City issues were yielding 10 per cent or more.

Seasonal pressures were evident in the short-term credit markets, and banks bid aggressively for CD's as tax- and oil-payment dates approached. A number of major banks were particularly aggressive in building up CD's in an apparent effort to cut back on their reliance on Federal funds by the year-end statement date.

Open market operations had to contend with large and erratic movements in market factors affecting reserves over the period. Banks also had problems in managing their own reserve positions with excess reserves unusually high in late November and early December. Reserves were added to the banking system through outright purchases of over $1 billion of Treasury bills, $212 million of Treasury coupon issues, $360 million of Government agencies and about $200 million of bankers' acceptances. Day-to-day reserve variations were handled by over $10 billion of repurchase agreements and about $8 billion of matched sale-purchase contracts, of which about half were made directly with foreign accounts. Activity for foreign accounts remains very heavy, particularly around oil-payment dates. Given the size of dealer inventories, availability of securities has been ample. In our go-around on Friday, for example, we were offered $2-1/2 billion Government agency securities--by far the largest offering of such securities that we have ever had. Dealer positions in agencies at the time amounted to $1.9 billion, somewhat less than what we were offered.

As far as the Treasury is concerned, it announced on Friday a yield auction of 2-year notes, set for December 23, to roll over a year-end maturity. In addition, it appears likely that the Treasury will have to borrow $1 to $1-1/2 billion to meet a low point in its cash position in early January. Tentatively, it has been considering the reopening of two coupon issues, but there is a possibility that a very large petro-dollar transaction may provide the Treasury with the cash it needs via an issuance of special securities directly to a foreign account.

As noted in a recent weekly report, the Desk has added another dealer firm--Blyth Eastman Dillon

> Capital Markets--to the list of firms with which we do business. This brings the number to 26, an all-time high. At the same time, we added another firm--Goldman Sachs--to the list of primary reporting dealers and we will probably add that firm to the trading list before long.

Mr. Black said it was not clear to him why commercial banks had not been more active in the market for municipals, in view of their increasingly cautious attitude toward lending and the widespread feeling that interest rates probably would decline further.

In reply, Mr. Holmes said he thought the main reason was that many of the larger banks that previously had been active in the municipal market now had sizable tax deductions which could be utilized only if they had taxable income. Accordingly, they had lost interest in tax-exempt income.

Mr. Coldwell asked whether another factor was not the increase in insurance coverage of public deposits and the consequent reduction in collateral requirements on such deposits.

Mr. Holmes said he doubted that that factor was of major importance, although the question might warrant further investigation.

Chairman Burns asked whether growing concern about the quality of some municipal issues might not be serving to restrain bank investments in such securities.

Mr. Holmes replied that there definitely had been growing concern about quality, particularly with respect to the issues of New York State, New York City, and certain other municipalities. He would have thought, however, that the assessments of relative quality were fully reflected in the wide yield differentials that had emerged; municipalities that were considered good risks could borrow at 5-1/4 per cent while others were forced to pay 10 per cent.

Mr. Hayes said it was possible that large New York City banks might be holding down their investments in municipals because they recognized that they were purchasers of last resort for the city's issues and wanted to maintain funds for possible use in that connection.

Chairman Burns remarked that such a course, if New York banks were in fact following it, seemed likely to ensure that they would have to act as purchasers of last resort.

Mr. Holmes noted that many nonbank security dealers had decided not to bid on New York City issues in January unless the situation changed drastically. They were relying on the large stake that New York City banks had in avoiding any possibility of default on outstanding debts by the city.

Mr. Mitchell observed that there was no question that market participants considered New York City securities to be poor risks and that they were justified in that view.

Mr. Morris expressed the opinion that the problem was not confined to New York. There appeared to be a generalized weakness in the municipal bond market stemming from technical strains, particularly the strains imposed by tax-exempt pollution control bonds. He might note, incidentally, that in his judgment granting tax exemption to such bonds represented extremely poor public policy.

Mr. Mitchell said he was not persuaded that the problem was one of generalized weakness. The Federal income-sharing program had provided enormous assistance to State and local governments in dealing with their financing problems. Moreover, the fact that good municipals were still selling readily at favorable yields suggested that the problem arose from large differences in quality.

In reply, Mr. Morris noted that municipal bond indexes based on high-grade municipals were now at record highs, and that yield spreads between such securities and high-grade corporate issues were very narrow by historical standards.

Mr. Holland remarked that the recent weakness in markets for high-grade municipals appeared, at least in part, to reflect the transition now under way toward sales of such securities on a more taxable basis.

Mr. Mitchell said it was clear that banks were now less interested in acquiring municipals than they had been for some time. That attitude no doubt reflected the problems banks had encountered in trying to meet the needs of REIT's and of necessitous borrowers generally, and their opportunity to charge off losses.

Mr. Axilrod commented that, from the investors' point of view, the problem appeared to be a genuine one affecting the municipal market as a whole. Banks, as had been noted, had not been active in the market. In addition, casualty companies had become less interested because reductions in profits had reduced their investible funds. Finally, he would hazard the guess that the interest of individual wealthy investors had declined partly because they were less certain than usual about their own tax brackets, and partly because erosion of tax receipts and the current widespread uncertainties made them doubtful about municipal securities in general.

In reply to a question by Mr. Coldwell, Mr. Holmes said he thought it should be possible to continue acquiring Treasury coupon issues in reserve-supply operations over coming months.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 19 through December 16, 1974, were approved, ratified, and confirmed.

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

During recent months, the staff's forecast of interest rates that are associated with particular M_1 growth rates has been gradually lowered in line with the weakening of actual and projected economic activity. Except for alternative D, all of the alternatives[1] presented to the Committee in the blue book[2] presume some further easing of the money market. Alternative D represents our estimate of the likely course of monetary aggregates if money market conditions are unchanged. Given the further weakening in projected GNP, that alternative lowers the longer-run growth rate for M_1 below the 5-3/4 per cent path that the Committee had previously considered to be desirable.

The easing in money markets that is implied to greater or lesser degrees by alternatives A through C would be consistent with the weakening in credit demands that has developed in short-term markets in recent months. The degree of easing implied by alternative C is modest. It involves raising the Committee's desired longer-run growth rate for M_1 to 6 per cent. Such a growth rate means that the shortfall below path of recent months would not be compensated for except over a longish period of time, with consequent downward effects on GNP, though probably minor relative to current projections.

Alternatives B and A--especially A--involve a more substantial easing of the credit market. As the blue book notes, alternative B involves an M_1 growth that makes up for recent shortfalls from the 5-3/4 per cent M_1 path by around mid-year, and contemplates a decline in the funds rate to around 8 per cent by the early weeks of next year. Alternative A involves a more rapid growth in M_1 and more substantial easing of money market conditions. Under this alternative, the level of M_1 would hit the old 5-3/4 per cent path by March, and thereafter--unless there were a substantial reversal of interest rate declines by late winter or early spring--would rise above that path at an average annual rate of about 7-1/4 per cent.

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

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

In weighing its monetary strategy over the weeks ahead, the Committee may wish to take account of four considerations.

(1) The technical position of securities markets, particularly bond and stock markets, is on the weak side. The municipal and corporate bond calendar is sizable and the volume of U.S. Government and Federal agency securities in dealer hands is large. Some further decline in short-term rates would, by reducing the costs to banks and dealers of carrying security inventory, help to stabilize bond market conditions. A rate decline would also lead to some further easing in mortgage markets, of course, as inflows to thrift institutions were sustained.

(2) Further declines in interest rates would be consistent with experience during the interest rate cycles of 1957-58, 1959-60, and 1969-71. In the first two cycles, the peak-to-trough movement lasted from 6 to 7 months, and short-term interest rates declined relatively much more than thus far in the current cycle. For example, the funds rate declined by 85 to 95 per cent in the earlier two periods (though starting from a relatively low level), while in 1974 it has declined about 35 per cent in the 5-1/2 months since its early-July peak. On the other hand, the funds rate is declining thus far this year at a relatively faster pace than in the 1969-71 period of declining rates--a period when the peak-to-trough movement in the funds rate lasted 15 months and the relative decline over that period was about 66 per cent.

(3) With regard to money supply, in light of recent shortfalls in M_1 growth relative to path, the Committee may wish to consider raising the upper limit of the 2-month ranges of tolerance for M_1 by about a percentage point.

(4) M_2 growth, on the other hand, has been fairly strong, though no stronger than we expected at the time of the last meeting. Thus, there are no shortfalls in M_2 growth to be compensated for. However, the Committee may wish to consider tolerating substantial M_2 growth, at least for a while, in order to accommodate expanding demands for liquidity on the part of the public, banks, and thrift institutions. At institutions, these demands are reflected in a continued reluctance to ease lending terms and standards in the current environment, even though interest rates have declined.

Mr. Morris noted that in his comments about recent shortfalls in the monetary aggregates Mr. Axilrod had implicitly taken August 1974 as the base for measuring longer-run growth rates. While he understood the reasons for the choice, he believed that June 1974 would be a better base; to use August was to omit 2 months of very slow growth in the aggregates, and consequently to understate the actual shortfall. Also, since Congress and the public tended to think of monetary growth rates in terms of quarterly periods, calculations based on June would be more readily understood. Assuming an August base was retained in the next blue book, it would be useful to add a chart showing longer-run growth rates measured from June.

Chairman Burns observed that the consequences of moving the base back in time depended on how far it was moved. As Mr. Morris had noted, the average growth rate would be reduced by a 2-month shift, back to June. It would be raised, however, if the base were shifted back further, since growth rates had been high in a number of months in early 1974.

Mr. Axilrod observed that the staff had proceeded from the premise that the Committee had faced the issue of the extent to which there should be compensation for earlier misses when, at its September meeting, it had first adopted a longer-run target measured from August.

Mr. Coldwell asked whether in preparing its projections the staff had modified the earlier assumptions regarding the length of lags, such as that between changes in money growth rates and economic activity.

Mr. Partee replied that no change had been made in the assumed lag between changes in money and activity.

Mr. Axilrod added that, similarly, there had been no change in the assumptions regarding the relationship between money and interest rates. However, a point that might be relevant to Mr. Coldwell's question was the one he (Mr. Axilrod) had made at the end of his statement--namely, that an apparent increase in the demand for liquidity was influencing lenders to maintain rather restrictive lending policies, despite the recent marked declines in short-term interest rates. Thus, the continued high degree of lender caution in the early stages of a downswing in interest rates was resulting in more credit rationing than might be expected at this point and a slower response to the effects of the easing than might otherwise be the case. He doubted that that situation would persist in the face of continued improvements in bank liquidity.

Mr. Coldwell asked whether the situation Mr. Axilrod described was not partly a consequence of the System's efforts to get individual banks to operate more prudently with respect to liability management and capital positions.

In reply, Mr. Axilrod said he thought bankers' experiences in the inflationary environment of the past year--particularly the inability of many borrowers to repay loans and the volatility of certain deposit flows--was a more basic cause of their current attitudes.

Mr. Bucher noted that during a meeting of economic consultants with the Board last week one speaker had criticized the strategy of fostering a gradual decline in the Federal funds rate. He had urged the System to focus on the level of interest rates rather than on the direction of movement, and to reduce the funds rate rapidly to the level that present recessionary prospects suggested would eventually be required, rather than stretch out the decline. He asked Mr. Partee for his reaction to that consultant's criticism.

In reply, Mr. Partee said that while he had not attended the meeting with the consultants he was familiar with the argument Mr. Bucher had cited. There was no doubt that a prompt, sizable decline in interest rates would have a greater impact on future spending behavior than a gradual decline, because it would reduce the incentive to postpone spending in the expectation of still lower rates. The difficulty with the proposal, as he saw it, was that it assumed certainty on the policy makers' part about the consequences of a radical change in interest rates. In recent years the Committee had been focusing more on monetary aggregate targets because of the problems it had experienced earlier with interest rate targets. At present there would be less risk associated with a reduction in interest rates than, say, 2 months ago, both because the aggregates had been falling short of the Committee's targets and because the economic outlook had weakened considerably. Even so, however, the precise consequences of a sharp reduction in interest rates remained unclear. Growth in the aggregates would be stepped up substantially, but it was hard to say by how much; and the effects, over time, that the rate reduction would have on expectations and on spending behavior were highly uncertain. To advocate a prompt, sizable reduction in rates was to ignore all such uncertainties.

Chairman Burns added that the proposed sharp reduction in interest rates would intensify the risk that a renewed rise in rates would occur at a time when economic activity was still receding--a risk that was minimized by the approach the Committee had been following. A marked interest rate reduction also could have highly disturbing consequences for foreign exchange rates.

Mr. Bryant observed that some foreign countries were constrained from following expansionary policies at present by balance of payments considerations as well as by domestic inflation, and would be more likely to move quickly toward stimulus if U.S. interest rates were to fall sharply. That group certainly included the United Kingdom and perhaps also Japan. As indicated in yesterday's staff presentation, such countries were looking to the United States and Germany to take some lead in resisting a cumulative world-wide recession.

The Chairman remarked that the United States had taken some lead in that regard--a fact which he thought policymakers abroad would acknowledge.

Mr. Wallich said he had a hypothetical question about the possible consequences of a discontinuous policy, involving a marked easing now, followed by a return to the prior policy stance after the objectives for economic activity had been achieved. He wondered whether the level to which interest rates would have risen at the latter point would be different from their likely level if policy had not been eased, but for some reason the objective for activity had been attained anyway. In other words, would a rise in rates be anticipated simply because the counter-cyclical policy was expected to be successful? Or was there something inherent in the behavior of markets that would produce a sharp rate advance in reaction to the discontinuous policy?

Mr. Partee replied that, while there probably would be some market response, he would expect interest rates to increase primarily because of the rise in GNP. He might note that a pattern typical of past business cycles was for the money supply to grow more slowly, or even decline, in the last stage of the boom and the beginning of the recession, and to grow rapidly after the recovery began. According to his recollection, the recovery phase of all postwar cycles had been marked by rapid monetary growth. If, as suggested by the staff's projections, real GNP began to recover in the second half of 1975, there would be a similar tendency for growth in money to accelerate. Indeed, that tendency was expected to be stronger than usual because of the anticipation of a continuing substantial rate of inflation; nominal GNP was projected to be growing at a rate of about 9 per cent. Presumably the Committee, which was now paying increased attention to growth rates in the monetary aggregates, would resist a sharp acceleration in money growth. Accordingly, increases in interest rates were likely to be sharper than at corresponding points in earlier recoveries.

Mr. Axilrod said he would offer an additional point. While a marked decline in interest rates would encourage recovery in activity, unemployment could remain substantial for a time. Under such circumstances, the Committee could be faced with the dilemma of either permitting what might appear to be a premature reversal of the interest rate decline as recovery began or permitting substantial reserve and money creation. Presumably the Committee would want to take that risk into account.

Mr. Wallich asked whether the staff thought a discontinuous policy of the kind he had suggested would result in a higher ultimate level of interest rates as well as a faster increase.

In reply, Mr. Axilrod remarked that it was difficult to be precise about the ultimate level of rates because of the problems of assessing, this far in advance, the effects on rates of any diminution of inflationary expectations. However, assuming the staff's GNP projections were reasonably accurate, a cutback in the rate of growth in M_1 from, say, 7 to 5 per cent in mid-1975 would undoubtedly be associated with a substantial increase in interest rates. If activity were weaker than projected the outcome for rates would, of course, be quite different.

Mr. Balles said he had been puzzled by the changes since summer in the ratio of currency to demand deposits. Normally, currency holdings increase more rapidly than demand deposits in a period of rising interest rates, because of the greater interest-sensitivity of demand deposits. This year, however, despite the fact that most short-term interest rates had been declining since the summer, the ratio of currency to demand deposits had continued to rise at a remarkably rapid pace. From July to November, for example, currency in the hands of the public increased by nearly $2-1/2 billion while demand deposits rose only $800 million. As a consequence of that development, the rapid rise in the monetary base had not been reflected in a proportional rise in M_1. He wondered whether the staff thought the rapid growth in currency was a transitory phenomenon or one which reflected some deep-seated trend perhaps related to uncertainty about the economic outlook. The issue was relevant to the Committee's policy decision today, since it affected the growth rate of the monetary base that would be required to achieve whatever rate of monetary growth the Committee decided upon.

Mr. Axilrod replied that the staff had noted the recent step-up in the growth of currency; monthly increases were now on the order of $600 million, compared with a more normal $350 or $400 million. A study had been undertaken of the reasons for that development but it was too early to say what the conclusions might be. He would add, however, that the behavior of currency did not constrain the growth of M_1 so long as the Committee employed reserve or Federal funds rate targets and not monetary base targets. With reserve and funds rate targets, the Desk automatically replaced any reserves that were drained from the banking system by increases in the volume of currency in circulation.

Mr. Bucher said he understood that the rise in currency holdings was particularly marked for bills of large denomination.

Mr. Partee commented that inflation could account for greater use of larger denominations.

Chairman Burns remarked that if one were to speculate on the causes of the shift to larger denominations, he might mention inflation; possibly some hoarding, because of diminished confidence in banks; and perhaps a certain marginal reluctance on the part of scattered retailers to accept checks as freely as formerly.

Mr. Mitchell noted that, in addition, some merchants had stopped accepting certain credit cards because of the costs involved.

Mr. MacLaury asked whether recent innovations in payments practices, including the one of making payments through thrift institutions, had proceeded far enough to begin affecting the behavior of the money supply. If so, he wondered whether the staff had a program for keeping the Committee informed of the nature and meaning of such structural changes.

Mr. Axilrod replied that a brief--and perhaps oversimplified--answer to Mr. MacLaury's first question was that such innovations had not yet gone far enough to affect M_1, but clearly were going to do so at some point in the future. The staff was monitoring developments with respect to NOW accounts in New Hampshire and Massachusetts, which were now of a size such that their addition to M_1 would affect the rounding of the first figure after the decimal in calculating growth rates. The staff also would be observing closely third-party payments practices at savings and loan associations and any similar developments with respect to the use of savings deposits at banks. At some point it probably would be desirable for the Committee to begin putting more emphasis on M_2 and M_3, or perhaps to begin using an indicator part way between those measures and M_1. It was hard to say just when that point would be reached, but he suspected it would be within a fairly moderate period of time.

Mr. Partee remarked that some newly defined monetary aggregate probably would be required. He added that thus far there seemed to be more talk than action with respect to the actual institution of new payment techniques--except, of course, for the NOW accounts in New Hampshire and Massachusetts. That, at least, was the conclusion he had drawn from an informal survey by the Reserve Banks a few months ago. The situation could change at any time, however, and it was important that the System be prepared to make any needed adjustments.

Chairman Burns asked whether there had been any recent studies of the turnover of time and savings deposits at commercial banks and thrift institutions.

Mr. Axilrod replied that to his knowledge no comprehensive information on that subject was available currently. Various studies had been made at times in the past, including some at the Chicago Reserve Bank under the leadership of Mr. Mitchell.

Mr. Mitchell added that the Home Loan Bank Board also had made one or two studies. In addition, time series on withdrawals from savings and loan associations were available.

Chairman Burns observed that the meanings of the various monetary aggregates had been in the process of changing for a number of years. He thought it would be desirable to have figures on the turnover of time and savings deposits at banks and thrift institutions, and of the M_2 and M_3 aggregates, made available to the Committee and the Board on a systematic and continuing basis.

Figures on turnover also should be presented systematically for M_1, the Chairman continued. The willingness to use money--that is, the rate at which money turned over, or its velocity--underwent tremendous fluctuations; velocity was a much more dynamic variable than the stock of money, and when no account was taken of it, any judgment about the growth rate of M_1 was likely to be highly incomplete. At one time analysts had tended to emphasize velocity. More recently, however, the emphasis had shifted to the money stock, and the subject of velocity was now relatively neglected in monetary discussions, including the Committee's own deliberations. For example, one of the gaps in yesterday's discussion was the failure to consider the turnover of demand deposits.

Mr. Mitchell said he agreed that the turnover of demand deposits was a highly relevant issue. A good deal of information on that subject was available, but the staff was not incorporating the data in its analyses and the System had been considering discontinuing its collection. He might note that turnover at New York City banks now exceeded 300 times a year.

The Chairman observed that Mr. Mitchell was referring to data on transactions velocity, whereas in his own earlier comments on M_1 he had had income velocity in mind. To illustrate the fluctuations he had mentioned, he might note that in the fourth quarter of 1970 income velocity of M_1 declined at an annual rate of about 4 per cent but in the very next quarter it rose at a rate of about 8 per cent. While that was a short-run movement, the data also indicated that there were enormous cyclical changes. It was clear that a low rate of growth in the money supply, if foretified by a large rise in velocity, could finance a rapid expansion in business activity; apparently that was the way the economy functioned.

Mr. Partee said he might note in defense of the staff that they had tried to make something of the data on transactions velocity but had not been able to. With respect to income velocity, the staff's projections included a measure, in the form of a strict relationship between the growth rates of the money supply and of income. That measure did change cyclically; for example, the income velocity of money implied by the judgmental projection declined at an annual rate of 2 per cent in the first two quarters of 1975 and then rose at rates of 3 or 4 per cent beginning in the third quarter. In the staff's view, changes in velocity were largely a function of interest rates. Thus, the decline projected in the first half of next year was in sympathy with the expected decline in interest rates, as well as a relative decline in the volume of transactions. The upturn expected after midyear was associated with the large increases anticipated in both interest rates and transactions volume.

Mr. Wallich said he would agree that changes in monetary velocity were important and that interest rates were a main determinant of them. He noted, however, that while income velocity was customarily measured in terms of current levels for both income and money, monetary effects were ordinarily viewed as occurring with a lag of 6 months or so. He thought it would be useful to take account of that lag by relating the current level of GNP to the level of the money stock 6 months earlier.

Mr. Bucher observed that, partly because of actions by the Board and other regulatory agencies, an increased proportion of savings inflows at banks and thrift institutions had been going into time certificates of deposit with long maturities and onerous withdrawal penalties. Those regulatory actions were probably having a major effect on the average rate of turnover of M_2 and M_3, apart from the effects of market interest rates and economic conditions.

Mr. MacLaury said he would stress the distinction between cyclical and secular developments. As Mr. Partee had suggested, cyclical changes in velocity might well be determined primarily by interest rates. His own concern, and evidently that of Mr. Bucher also, was with secular changes. The latter might well require changes in definitions of the monetary aggregates.

Chairman Burns remarked that he would seriously question the linking of income velocity to interest rates exclusively. That would be correct if and only if interest rates determined the volume of economic activity. In fact, however, interest rates were one among many factors that determined activity.

Mr. Axilrod asked whether his understanding was correct that the Committee wanted to know whether the rate of turnover of various types of deposits was moving up toward that of demand deposits as one means of determining whether the definitions of the monetary aggregates should be adjusted. If so, he thought the point Mr. Bucher had made should be underscored. The growth of 4-year time deposits, which to his mind were similar in character to notes and bonds, was tending to reduce turnover of total time deposits. Other kinds of secular developments no doubt were tending to raise turnover.

The Chairman commented that it was important to check the definitions of the aggregates. However, it was no less--and perhaps more--important to consider how the aggregates were used. If, as he suspected, time deposits increasingly were taking on the characteristics of demand deposits, the Committee should be paying progressively more attention to M_2. The Committee had shown a tendency, to which he had contributed, of emphasizing M_1 heavily--sometimes, it seemed, almost to the exclusion of the other aggregates. It should be recognized, however, that the world was not standing still. In his judgment, studies of the velocity of various types of deposits would be extremely useful. He thought work along those lines should be organized and carried out despite the expense that might be involved.

Mr. Mayo remarked that very little was known about the turnover of currency. Because of that lack of knowledge, the subject was largely ignored.

Chairman Burns observed that changes in turnover of currency would, of course, be reflected in measures of the income velocity of M_1. While such measures were available, hardly any attention was paid to them. In his view, income velocity was a far more important variable than the rate of growth of the money stock.

Mr. Partee referred to the proposed studies of various types of deposits and said he was concerned about the point Mr. Bucher had made. Virtually all of the increase in time deposits in recent years had been in the form of certificates, which had a low turnover. Thus far, staff efforts in the area had been focused on obtaining additional information on passbook savings as and where they seemed to take on a high degree of moneyness. Data were now being collected on NOW accounts, and the Federal Home Loan Bank Board had been advised that the System would want information on accounts that offered third-party payment privileges as they were authorized. The development of systematic data on turnover of, say, all passbook savings deposits at banks and at savings and loan associations would involve a large and expensive collection effort.

Chairman Burns said he recognized that fact.

Mr. Mitchell observed that the data available for past periods would offer a good base on which to build.

Mr. Wallich commented that under current circumstances much of the growth in demand deposits was likely to originate in the acquisition of securities by banks. Since the stimulative effects of expansion in bank holdings of short-term securities was much less than that of loan expansion, it would be desirable for the Committee to pay more than the usual amount of attention to changes in the composition of the assets of the banking system.

Chairman Burns then called for the Committee's discussion of monetary policy and the directive, noting that the decision to be reached today was of greater than ordinary importance. To begin, he would make a few comments of his own. First, the Committee had taken action to ease money market conditions gradually over recent months, in recognition that the economy was moving into a recession. In his opinion, any drastic change in that policy course would be a great mistake, although some further easing would be appropriate. He hoped that the members would continue to bear in mind that inflation remained a serious problem, that the inflation was largely responsible for the current recession, and that failure to bring inflation under control would aggravate some of the country's longer-term economic problems. Second, monetary policy was only one of the policy instruments available. At present the Administration was engaged in a serious and thorough reappraisal of economic policy, and significant steps would be taken to limit the recession and to initiate forces of recovery; the only uncertainty concerned the shape and scale of the measures to be taken. Finally, the money stock was a highly complex economic variable, as this morning's discussion had demonstrated.

Mr. Bucher, recalling his earlier question regarding criticism of System policy by one of the Board's economic consultants, said he agreed with Mr. Partee's response. Also, he was in agreement with the remarks that the Chairman had just made. He shared the staff's concern about the strength of recessionary tendencies and was aware of the arguments favoring a more drastic easing in policy, but he did not think such a policy would be appropriate at this time. For a number of reasons, he believed that policy should continue to be eased gradually. Like the Chairman, he believed that stimulative fiscal actions would be taken, and he thought that such actions in all likelihood would be larger in scope that those assumed for purposes of the staff projection. Second, he thought that consumer psychology should improve in the second half of 1975 and, consequently, that the upturn in economic activity might well be stronger than the recovery projected by the staff. Third, monetary policy no longer could have much effect on economic activity in the first half of next year. Finally, press comments, the behavior of the stock market, the gold fever, and perhaps also the increase in currency holdings testified to a loss of confidence in the financial system. In those circumstances, System actions that might be perceived as panic reactions would be counter-productive in that they would induce a further deterioration in confidence, having adverse consequences for both the international situation and the domestic economy.

Accordingly, Mr. Bucher said, he preferred to continue policy on the course that it had been on in recent months. He would counter any tendency for interest rates to move back up, and preferred that rates decline slowly. Believing that specifications approximating those of alternative B were consistent with his objectives, he favored that alternative.

Mr. Hayes observed that he agreed with the Chairman's remarks concerning the problems now being faced, and he agreed also that fiscal policy was likely to become more stimulative. With respect to the economic situation and outlook, the assessment of the staff at the New York Bank was very similar to that of the Board's staff. The situation undoubtedly was weaker than had been thought even a month earlier, and like Mr. Partee, he would stress that the projections did not take account of possible shocks and financial turbulence. On the other hand, the inflation threat remained. Unless a pronounced reduction in the rate of inflation was achieved within the next year or so, the outlook for the behavior of prices in the next economic upturn and over the longer term would be particularly troublesome. Moreover, a good deal of attention had to be paid to the international situation. In the process of easing monetary policy, it would be undesirable for the United States to get too far ahead of major European countries.

With those thoughts in mind, Mr. Hayes remarked, he believed that the Committee should seek to assure adequate but moderate growth in the monetary aggregates over the months ahead, avoiding any actions that might even suggest that the economy would be flooded with easy credit. If short-term interest rates declined further in the absence of excessive monetary growth, he would be pleased. Accordingly, he preferred the specifications of alternative C, but with two modifications. In view of the New York Bank's projection of a 3 per cent rate of growth in M_1 over the December-January period, he would specify a 2-month range of 3 to 7 per cent, rather than 4-1/2 to 6-1/2 per cent as in the blue book, in order to lessen the probabilities that it would become necessary to seek a Federal funds rate at the lower end of its specified range. And he would prefer a range of 7-3/4 to 9-1/4 per cent for the funds rate, rather than 7-1/2 to 9-1/4 per cent, to establish a midpoint of 8-1/2 per cent. He hoped that the Desk would aim to move the rate down to the midpoint promptly, and then move the rate down further if incoming data suggested that growth in the aggregates was weak. He liked the language of alternative B, except that following the statement "...the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat more rapid growth in monetary aggregates over the months ahead" he would add "than has occurred in recent months," in order to avoid a possible inference that the Committee was seeking a more rapid rate of growth than the 7 per cent of November.

Chairman Burns said he agreed that if the Committee wished to adopt the language of alternative B, it would be desirable to modify it in the manner and for the reasons that Mr. Hayes had suggested.

Mr. Morris commented that for a number of months he had felt that the Committee had pursued an easier monetary policy much too gradually and, consequently, that it had helped to produce a deeper recession than was socially useful. In other words, the slack in the economic system would be greater than the amount required to diminish the rate of inflation; an 8 per cent rate of unemployment--as was now projected for the second half of 1975--was not needed in order to achieve that objective. At the same time, he was concerned that the Committee had not achieved its objectives for monetary growth in the second half of 1974 and that as a result it had produced a more restrictive financial climate than it had sought. It seemed unlikely, in retrospect, that any member of the Committee would have advocated the 3.5 per cent annual rate of growth in M_1 that would be recorded for that period. In his opinion, the Committee had not achieved its objectives for growth in the aggregates in late 1974 for the same reason that it had not done so in the second half of 1968 and in the second half of 1972: now as then, the Committee was reluctant to move interest rates to the necessary extent.

At this juncture, Mr. Morris continued, it was important to make up the shortfall in monetary growth and to do so at a fairly rapid pace. He believed that monetary policy still could have some impact on developments in the latter part of 1975, and the Committee was obliged to take steps to mitigate the severity of the recession. Consequently, he favored alternative A, which was expected to result in M_1 growth of 5.5 per cent over the 12 months ending in June 1975. However, growth in the first half of 1975 would be at a 7-1/4 per cent rate, and he would not advocate that fast a rate of growth for more than 6 months. Once economic activity began to recover, the target for monetary growth should be reduced.

Mr. Morris remarked that he hoped such a policy position would not be described as pushing the panic botton. In any case, he would prefer that the phrase be abandoned, because it imputed a degree of moral weakness to a particular policy judgment. He believed that such a more expansive policy and further reductions in short-term interest rates in the immediate future would help to ease the financial strains in some sectors of the economy and would increase the chances for economic recovery in the second half of next year by contributing to a revival in residential construction activity and by hastening the inventory correction.

Moreover, as he had suggested at the November meeting of the Committee, monetary growth tended to fall short during recessions, just as it tended to overshoot during expansions, and pursuit of alternative A would lessen the risks of inadequate monetary growth in the period ahead. The Committee would face a more difficult problem next summer. Once the economic revival began, as had been noted in the excellent staff presentation yesterday, control of the monetary aggregates would necessitate a rise in short-term interest rates. One could argue for pursuit of a more conservative policy at this time in order to moderate the reversal in short-term rates next summer, but he believed that it was more important now to adopt a policy that would mitigate the severity of the recession.

Mr. Mayo commented that, while understanding Mr. Morris' point of view, he believed that it exaggerated the role that monetary policy could have in influencing the course of economic activity in the next 6 to 12 months. He was concerned that a policy that was too expansive at this time would intensify the problems to be confronted next spring. He was concerned also that fiscal policy would prove to be even more expansive than anyone now anticipated; in its anxiety to fight recession, the Administration's program for fiscal stimulus was likely to exceed current expectations, and the Congress was likely to go beyond Administration proposals. The resulting fiscal policy, and the need to accommodate sizable Treasury financings next autumn, likely would exert upward pressure on the rate of monetary growth as well as on interest rates. To the extent that the Committee could act now to temper those pressures, it had a responsibility to do so.

In that light, Mr. Mayo said, he favored the specifications of alternative B; that alternative was intended to make up the shortfall in M_1 growth by next June. He believed that the range of 7 to 9 per cent for the Federal funds rate was just about right, although he might shade it a little in the direction of the 6-1/4 to 8-1/2 per cent range of alternative A. After the beginning of the new year he would watch for opportunities to reduce reserve requirements further and to cut the discount rate again. At that time, such policy signals might be appropriate.

Mr. Black observed that he agreed with the staff's assessment of the outlook for economic activity. Clearly, the recession was going to be deeper and was likely to last longer than generally had been thought 6 months ago. Nevertheless, in view of the severity and the persistence of inflation over the past year, monetary policy had been just about right. It was not at all clear that monetary policy had contributed to the present downturn or that anything could have been done to improve the situation without producing undesirable side-effects. Now, however, the time had come for some stimulative measures with respect to either fiscal policy or monetary policy. Like others, he anticipated more stimulative fiscal measures, and he would want to bear that in mind in formulating monetary policy. It was important to look beyond the trough in economic activity so as to attempt to avoid the development of an unsustainable, inflationary boom that would intensify problems later on and cause another and more serious recession. The risks arising from an overly enthusiastic effort to promote recovery were great, especially because of the unprecedented inflation over the past 10 years.

For the present, Mr. Black concluded, the Committee ought to avoid any substantial acceleration in the rate of growth in money and credit. However, it was important that the Committee take whatever action was necessary to restore growth in M_1 to the path contemplated earlier in the year--that is, to a 5-3/4 per cent growth path from the August base. Such action was desirable not only to make up for the shortfall but to allow for the probable decline in the income velocity of money as economic activity declined further. To restore growth to the 5-3/4 per cent path, he inclined toward the longer-run targets of alternative B, but he was concerned that the further sharp reduction in the funds rate associated with that alternative would risk overly rapid monetary growth in the months ahead. Therefore, he prefered specifications between those of alternatives B and C. Specifically, he favored a funds rate centered on 8-1/4 per cent, with limits of 7-1/2 and 9 per cent. He hoped that in the December-January period the aggregates would grow at rates more or less in accordance with the specifications of alternative B, but he would be reluctant to specify longer-run targets any higher than those of alternative C.

Mr. Wallich observed that until now, the new information at each Committee meeting had suggested that the situation was worse than had been expected a month earlier with respect to both the developing weakness in the real economy and the rate of inflation. The two types of deterioration compensated for one another and suggested that monetary policy be held stable. This month, however, while the economic outlook again appeared to have deteriorated, the outlook for inflation had not worsened further and might even have improved. That created an opportunity for a policy response.

Mr. Wallich remarked that a policy of complete stability in the rate of monetary growth still had certain attractions.

In particular, it would help in the Committee's effort to avoid inferences that it had given up the fight against inflation, an effort that had been marked by a considerable measure of success thus far. Such a policy also commended itself because it was a good way to avoid the mistake sometimes made in the past of overreacting to changes in the economic situation. However, a policy of completely stable monetary growth would clearly be second best under present circumstances; a better course would be to seek a rate of monetary growth somewhere between a stable rate and one reflecting an overreaction. Even such a course, however, if continued indefinitely, would run the risk of provoking an inflationary expansion in activity, as had occurred in the past. That could come about either through an immediate recovery leading to a prompt resurgence of inflationary pressures or, more likely, through a delayed recovery leading to an accumulation of liquidity that would fuel an inflationary surge later on.

Alternatively, Mr. Wallich continued, the Committee might pursue a more expansive policy on a temporary basis, building in safeguards to ensure that the rate of monetary growth would be cut back in time to avoid a massive surge in economic activity later on. As suggested by the analysis in the blue book, a temporary acceleration in the rate of monetary growth might be regarded as a means of making up for last summer's shortfall from the Committee's longer-run targets; once the shortfall had been made up, the rate of growth would be slowed. When viewed in that light, the subsequent slowing in the rate of monetary growth should receive considerable public support, even though the resulting increase in interest rates would, as always, provoke dissatisfaction. One possibility would be for the Committee to announce that it would seek a more rapid pace of monetary growth for 6 or 9 months and then would slow growth to a rate that generally was regarded as consistent with halting inflation. Such an announcement--through its effect on expectations--probably would serve both to bring interest rates down more promptly than otherwise and to avoid some of the upturn in rates that would normally occur at the time monetary growth was slowed. That approach, which was similar to the one recently taken by the German authorities, would represent a departure for U.S. monetary policy and would have to contain some escape clauses.

If the Committee agreed on an increase in the rate of monetary growth that would be only temporary, Mr. Wallich said, he would favor the specifications of alternative A. Otherwise, he would favor the B specifications.

Chairman Burns remarked that the German authorities, in announcing their monetary targets, intended to give notice to the business community and, in particular, to the labor unions that prices and wages somehow would have to adjust within those parameters of monetary policy. Thus, the policy was designed to promote restraint in price and wage determination. The authorities would be in a position to say to one group or the other that its actions were impeding the Government's policy to restimulate the economy. In the political setting of the United States, the Government was not equipped to do that.

Mr. Wallich noted that he had circulated to Committee members a short summary of the discussion at the BIS meeting on December 9, which included some comments on the German policy.

Mr. Kimbrel observed that economic developments in the Atlanta District appeared to be about as gloomy as elsewhere in the country, and the staff at his Bank now believed that the recovery in activity would develop even more slowly in the second half of next year than suggested by the projections in the green book. Confidence was continuing to weaken, and inflation remained a pervasive influence on business decisions--although further moderation in the rate of increase in prices would bring about some improvement in attitudes. With respect to the behavior of banks, the System directly or indirectly had contributed to some rebuilding of liquidity. It appeared unlikely that the banks immediately would relax their lending standards even if additional funds suddenly should become available, and strong efforts by the System to bring about such a change would not be productive.

Continuing, Mr. Kimbrel remarked that in the past the System often had over-reacted to recessionary developments, and he believed that the recent policy of pursuing a gradual easing had been appropriate. If the recovery proceeded more slowly than projected, that might argue for some slightly faster monetary growth. At the same time, however, he was impressed by the probabilities that measures to ease fiscal policy would be both significant and prompt. With that prospect in mind, he believed that any action now that significantly reduced interest rates might force the Committee to face the difficult decision to raise rates later on at a time when the unemployment rate was still undesirably high. At this time, international considerations also argued against a further easing of interest rates.

Accordingly, Mr. Kimbrel said, he preferred the specifications of alternative C, although he would not want to see the Federal funds rate rise above 9 per cent. He hoped that in the near term it would be within a range of 8-1/4 to 8-1/2 per cent.

Mr. Francis remarked that the current decline in economic activity differed from past recessions in a number of respects. First, it was one of the few declines, if not the only one, to have developed without having been preceded by stabilization policy actions that brought it about. Second, there had been an absolute decline in the country's capacity to produce, caused by the agricultural and energy problems, by the distortions resulting from the wage and price controls, by the new environmental and safety standards, and by changes in foreign exchange rates. When recovery in economic activity began--and he believed that it would begin before long--less idle capacity would be available than might be supposed. As a result of those developments, some redistribution of wealth had occurred; the standard of living, on average, had declined; and the value of the nation's capital stock had been reduced.

With respect to inflation, Mr. Francis observed that the rise in prices in 1974 was just about double the increase that he would have expected to result from the policy actions that had been taken. Special factors, such as the energy and agricultural problems, had contributed to the rise in prices in 1974. However, those factors would not continue to exert strong upward pressure in 1975, and the rate of inflation would subside. If that view was borne out, and if the country did not embark on a massive program to fight the recession, confidence in the dollar might be restored.

Noting that growth in M_1 over the second half of 1974 would be at an annual rate of less than 4 per cent, Mr. Francis remarked that a somewhat faster rate would be desirable in the first half of 1975. Accordingly, he favored alternative D, which specified a longer-run target of 5-1/2 per cent. Greater injections of money were not needed at this time.

Mr. Eastburn commented that the issue today was whether or not the Committee would attempt to fine-tune monetary policy. To many, it would be desirable to accelerate monetary growth for a time and then to slow it later on, especially in view of the lags with which monetary policy affected economic activity. However, that could involve larger fluctuations in interest rates than the public was prepared to accept. Therefore, although his instincts led him toward alternative A, he favored alternative B as a more practical and safer course. Concerning the short-run targets, he would agree to widen the ranges for the aggregates.

Mr. Coldwell remarked that he had little doubt that the recession was deepening and broadening. Public policy responses, which so far had been fairly well restrained, were likely to become more aggressive and more visible. Monetary policy had to be adjusted to the new degree of weakness in the economy, but the policy response had to be restrained in order to avoid creating an excessive amount of reserves and having an adverse impact on expectations. Monetary policy could make its greatest contribution by continuing to ease on a slow and steady course.

Mr. Coldwell said he would prefer an operational paragraph for the directive couched in terms of money market conditions, primarily because he had very little confidence in the money supply statistics. Thus, he would say "To implement this policy while taking account of developments in the domestic and international financial markets, the Committee seeks some further modest easing of bank reserve and money market conditions expecting that monetary aggregates will continue to expand at a moderate rate in the months ahead." With that language, he would associate the longer-run targets of alternative C and the short-run specifications of alternative B. A Federal funds rate range of 7 to 9 per cent, as under alternative B, seemed appropriate. He would like the Desk to move the rate down gradually to the neighborhood of 8 per cent by the time of the next meeting in mid-January, resisting any tendency for it to rise above 9 per cent or fall below 7 per cent.

Mr. MacLaury observed that he, like Mr. Morris, thought that yesterday's staff presentation was excellent. He agreed that the outlook for economic activity was quite weak and that prospects for the behavior of prices were less discouraging than they had been. In his view, it was questionable that recovery in activity would develop in the second half of next year. Although he would not accept the real money supply as a policy target, he was discouraged by its rapid decline in recent months--a decline that had resulted in part because the Committee had not achieved its targets for growth in the nominal money supply in the third and fourth quarters of this year. Because of that shortfall, he would urge caution in claiming that policy had been eased over recent months. Policy had eased in terms of interest rates but not in terms of growth in the monetary aggregates.

Mr. MacLaury said he believed, as he had at the time of the last meeting, that it would be appropriate to raise the Committee's longer-run objectives for monetary growth, and he would accept the longer-term targets of alternative B. However, to increase the chances that those targets would be achieved, he would adopt the short-run ranges for the aggregates of alternative A. With them, he would associate the Federal funds rate range of alternative B, which probably would result in the funds rate being moved to the lower limit of its range. Like others, he was aware that the problem of an upturn in interest rates would have to be faced next year, as it had been in 1972 and earlier periods. The suggestion made by Mr. Wallich might, perhaps, offer a way out. Another, if weaker, suggestion was to advocate publicly a monetarist view--perhaps more strongly than most Committee members normally would prefer--in order to foster acceptance of the idea that the System was pursuing a growth path for the aggregates and tolerating whatever interest rate changes developed. Such a strategy might, perhaps, mitigate the essentially political problem that would be created by increases in interest rates at a time when the unemployment rate was still very high.

Mr. MacLaury added that he concurred in the Chairman's remarks of yesterday afternoon concerning cyclical versus longer-range problems of economic policy. He believed that Federal Reserve officials might make a contribution to public understanding of those problems through speeches and other means.

Chairman Burns said he had an uneasy feeling that too much emphasis tended to be placed on the behavior of the money stock and too little on the income velocity of money--which, as he had observed earlier, was subject to tremendous fluctuations.

Fundamentally, velocity depended on confidence in economic prospects. When confidence was weak, a large addition to the money stock might lie idle, but when confidence strengthened, the existing stock of money could finance an enormous expansion in economic activity.

Continuing, the Chairman observed that a great deal of attention had been drawn to the shortfall in monetary growth during the summer. Whether there had been a shortfall in a meaningful sense, however, depended on the length of the period chosen for the measurement of growth. Taking a somewhat longer period, one could argue that there had been an overshoot rather than a shortfall. A policy geared to compensating for every shortfall would be too mechanical. If the Committee followed such an approach, additional shortfalls in the period ahead would result in successive increases in the growth target--for example, to 7 or even 7-1/2 per cent. Once the shortfall finally had been made up, the Committee then would have to face the difficult problem of slowing the rate of monetary growth. The members might plan now to slow growth later on, but when the time arrived, they would find it a difficult step to take.

Chairman Burns remarked that for some months, the long-run target for growth in M_1 had been at an annual rate of 5-3/4 per cent, and he believed it made sense now to raise the target to 6 per cent. That would be well above the rate required to achieve the objective of returning the economy to a path of long-run price stability; the long-run rate of monetary growth consistent with long-run price stability probably was 2 per cent. In accepting a rate of 6 per cent, therefore, he recognized that it represented an accommodation of a considerable degree of inflation. For the December-January rate of growth for M_1, he would set a range of 4-1/2 to 7 per cent or 5 to 7 per cent. Concerning the Federal funds rate, it would be a mistake to aim for a reduction as great as 1-3/4 percentage points in a 4-week period; therefore, he would set the lower limit of the range at 7-1/2 per cent. At the same time, he would not want to see the rate go up, and so he would set an upper limit of 9 per cent.

Mr. Balles observed that on some grounds he was tempted to join Mr. Morris in advocating alternative A, particularly since one of the great advantages of monetary policy was its flexibility. A primary reason for that temptation was the expectation of a much sharper decline in economic activity than had been expected several months ago. The current recession might prove to be nearly L-shaped, with a sharp decline followed by only a sluggish recovery. In view of the longer-term problem of inflation, however, he viewed that as a risky course. If the rate of inflation were still high when the recovery in activity began, it could well undermine the viability of the capital markets over the longer term. As he had indicated a month ago, if the rate of inflation now were 6 per cent rather than nearly twice that rate, and if there were no strong fiscal stimulus on the horizon, he would favor a policy as expansive as alternative A, if not more expansive. As far as the outlook for inflation was concerned, he was skeptical that the rate of price increase would slow as much as suggested by the staff projections.

All things considered, Mr. Balles said, he favored alternative B. Under that alternative, the annual rate of growth in M_1 from the fourth quarter of 1974 to the second quarter of next year would be 6.6 per cent, on the quarterly average basis. He favored such a rate, even though normally it would be unacceptably high in terms of the objective of returning to a path of price stability, because he believed that the income velocity of money would decline over the next several quarters. For the Federal funds range under alternative B, he preferred not to raise the lower limit of the range to 7-1/2 per cent, as suggested by the Chairman, and was inclined to let the rate go below 7 per cent, if necessary to achieve the targets for the aggregates. In his view, the Committee's target for M_1 growth had not been achieved in part because the funds rate constraint had interfered with the provision of an adequate volume of reserves.

Mr. Holland commented that yesterday's staff presentation, which necessarily had been limited in the number of policy options that it could review, had not considered a policy course that allowed for an inflection in the rate of monetary growth at some point during the projection period. In his view, a policy adjustment was needed now, and another adjustment would probably be needed again in the spring or early summer. Somewhat more accommodating monetary conditions were appropriate in the present circumstances of deepening recession, although conditions should not be made so easy as to thwart the dampening of inflation that seemed to be under way. Such a policy course had to take account of the more stimulative fiscal policy in prospect and of international pressures. A dramatic drop in interest rates now would have unfavorable consequences internationally. His preference was for continuation of the gradual decline in interest rates along with moderate growth in the monetary aggregates.

Continuing, Mr. Holland observed that in the present situation he would stress the behavior of M_2 and M_3 much more than that of M_1 for the principal reason that the financial system was in the process of making a stock adjustment. Both banks and nonbank thrift institutions were in very illiquid positions and were working hard to improve their liquidity. The improvement was desirable so that those financial institutions would be better able to weather the shocks to confidence and other problems in prospect next year. Moreover, the improvement probably had to occur before the institutions would be willing to relax their lending terms and conditions significantly. Consequently, he advocated a sizable increase in the inflow of time and savings deposits to banks and to savings and loan associations in order to facilitate the stock adjustment so that by late winter or early spring both kinds of institutions would gradually ease their lending policies. He also hoped for rates of growth in M_2 and M_3 that were higher relative to growth in M_1 than projected by the staff, and he believed such higher rates were reasonable as well as desirable.

Accordingly, Mr. Holland said, he favored a long-run rate of growth of around 9-3/4 per cent for both M_2 and M_3, as shown under alternative B, and he believed that would be consistent with the 6 per cent growth rate for M_1 shown under alternative C. For the short-run targets, he favored ranges close to those under alternative B. Thus, he could accept a range of 5 to 7 per cent for M_1, as suggested by the Chairman, and a range of 7-1/2 to 10 per cent for M_2. He believed that those rates of growth could be achieved with a Federal funds rate range of 7-1/2 to 9 per cent, provided that the Manager used the entire range;

he would urge that the rate be moved all the way down within its range by the time of the next meeting, if necessary in order to achieve the targeted rates of growth for the aggregates. With respect to the mix of policy instruments, he expected that he would be an advocate of further action to reduce reserve requirements. Finally, he favored the language of alternative B, as modified by Mr. Hayes, but he preferred to call for more "vigorous" rather than more "rapid" growth in monetary aggregates.

Mr. Mitchell remarked that yesterday's staff presentation had confirmed his view about the outlook for economic activity. If the staff's projection was seriously in error, he believed the probability was very high that economic activity would be much weaker than projected, and he was dismayed that the situation seemed to have got that far out of hand.

Mr. Mitchell said he could think of no time when the monetary aggregates were less useful for policy purposes than they were now. That view was crystalized by the sharp decline in real money balances that had been noted in the staff presentation. The decline--rather than suggesting that the bottom was falling out--pointed up the importance of taking note of the secular uptrend in the turnover of money. He believed that uptrend had been and continued to be strong. Another uncertainty in the interpretation of the monetary statistics arose in connection with Euro-dollars; he suspected that at least some part of the Euro-dollar-based money supply should be included in the U.S. money supply. More generally, he thought M_1 was becoming increasingly obsolete as a monetary indicator. The Committee should be focusing more on M_2, and it should be moving toward some new version of M_3--especially because of the participation of nonbank thrift institutions in money transfer activities. Some of those institutions were offering 5-1/4 per cent on time accounts from which funds could be transferred into a demand deposit by making a telephone call.

Continuing, Mr. Mitchell said monetary policy by itself could not turn the economy around; some contribution from fiscal policy would be desirable. However, monetary policy could make a unique contribution by achieving a lower level of interest rates. His primary objective would be to achieve a level of rates that would encourage the increased volume of borrowing in mortgage and capital markets essential to the kind of revival in economic activity that would be needed in 1975. The operation would be a tricky one because efforts to achieve somewhat lower rates could give rise to expectations of further reductions, which would defeat the purpose. Perhaps the best policy would be one that provoked vigorous criticism both from those who thought easing was being carried too far and from those who thought it was not being carried far enough. Such a policy, if it could be achieved, would generate real uncertainty as to the course of interest rates. With respect to the policy choices suggested by the staff, therefore, he favored a course between alternatives A and B.

At this point the meeting recessed. It reconvened at 2:30 p.m., with limited staff attendance. Following comments by Chairman Burns on the possible nature of the Administration's economic proposals, the meeting continued with the same attendance as at the morning session.

Mr. Sheehan observed that a degree of optimism seemed to have developed regarding the rate of inflation. If the staff projections proved to be correct and the annual rate of increase in the GNP deflator fell to about 5.5 per cent by the second quarter of 1976, considerable progress would have been made, but that was still a very high rate. And because of certain structural problems, including particularly those having to do with the determination of wages, he was skeptical that inflation would abate to that extent, even though prices of some commodities were likely to decline. In the last few days, steel prices had been raised by about 10 per cent, and one airline had announced a dramatic increase in wages. Although it was also true that a sizable cut in wages had been announced by another airline, that company was on the verge of bankruptcy.

Continuing, Mr. Sheehan remarked that the fiscal policy response to the recession was likely to be excessive, and he agreed with those who held that Federal Reserve policy had been and could continue to be a steadying force over the next 6 to 12 months. He would avoid a substantial shift in policy, as had been made so often in the past, preferring to continue on the track of gradual easing. So far, the System had not pursued a policy that could be characterized as giving up the fight against inflation, and he hoped that it would not do so now.

Mr. Sheehan observed that, like some other members of the Committee, he believed that a considerable amount of attention should be given to M_2, which had grown at a substantial rate in October and November. For the period ahead, he preferred specifications closer to those under alternative C than under alternative B. For the Federal funds rate, he favored the range of 7-1/2 to 9 per cent that the Chairman had suggested; he would not want to see the rate rise, nor would he want to see it decline over the next 4 weeks by as much as would be possible under alternative B.

Mr. Winn remarked that, although the staff presentation had been excellent, the view of prospective economic developments was likely to change as much over the next 3 months as it had over the past few months. Thus, the Committee's targets also would be subject to change. In light of the considerable uncertainty regarding the outlook and also because of possible shocks to the economy that could not be foreseen, he would tend to follow a middle-of-the-road policy. Accordingly, he favored specifications between those of alternatives B and C.

Mr. Clay observed that the recession under way and the increase in unemployment were necessary to some degree in order to reduce the rate of inflation, and he saw some signs that the rate was slowing. The rise in unemployment tended to provoke the reaction that the money supply ought to be expanded more rapidly, but the System had as much responsibility to seek price stability as it did to pursue full employment. In any case, the current recession had not been caused by an inadequate supply of money. Over the past 3 years, M_1 had grown at an average annual rate of more than 6 per cent--a rate widely regarded as excessive. The excess money that had been created would be available to finance expenditures when the economic climate improved.

Mr. Clay said an increase in the rate of monetary growth at this time would not solve the country's economic problems. On the contrary, an excess of money would encourage various kinds of inefficiencies and would raise the rate of inflation, leading to still higher unemployment later on. The Committee should focus its attention on pursuing a rate of monetary growth that would restore efficiency and price stability. To begin to achieve that, he favored alternative D. Recognizing that he had little support for that preference, however, he would accept alternative C.

Mr. Baughman observed that views concerning the economic situation had been undergoing change and no doubt would continue to do so in the period ahead. At their latest meeting, the directors of the Dallas Bank uniformly had reported that over the period since their preceding meeting activity in the industries with which they were familiar had weakened substantially. And similarly, he expected that the staff's assessment of economic prospects would continue to change, although he thought yesterday's presentation was excellent.

Mr. Baughman said consideration of the Committee's longer-run targets for monetary growth needed to take account of the reduction in capacity that Mr. Francis had called attention to. In making a judgment about the appropriate rate of monetary growth, the Committee more or less was deciding how much of the inflation it would validate. He would not quarrel with the M_1 growth rate of 5-3/4 per cent that the Committee had pursued for some time--a rate which, in his judgment, was about twice that required to meet the economy's needs in a situation of stable prices. Consequently, he would accept the specifications of alternative C.

Chairman Burns suggested that the Committee consider first the language for the operational paragraph of the directive. He believed that the main choice was between alternative B as modified by Mr. Hayes and Mr. Coldwell's proposal, and he suggested that the members be polled with respect to their preference between the two versions.

The poll indicated that a majority preferred the language of alternative B as modified by Mr. Hayes.

With respect to the longer-run targets, the Chairman observed that most members appeared to favor either alternative B or alternative C, and he called for an informal expression of preference with respect to those alternatives.

A majority of the members expressed a preference for the longer-run targets of alternative C.

The Chairman then asked the members to indicate informally whether they could accept a range of 7-1/2 to 9 per cent for the weekly average Federal funds rate in the period until the next meeting.

A majority of the members indicated acceptance of that range.

In response to a request by Mr. Mitchell, the Chairman asked the members to indicate whether they would accept a lower limit of 7 per cent, rather than 7-1/2 per cent, for the funds rate range.

A majority of the members indicated that they preferred 7-1/2 per cent for the lower limit.

Chairman Burns asked the members to indicate whether they could accept the following ranges of tolerance for the annual rates of growth in the aggregates over the December-January period: 5 to 7 per cent for M_1, 7-1/2 to 9-1/2 per cent for M_2, and 9 to 11 per cent for RPD's.

A majority indicated acceptance of those ranges.

Mr. Winn asked whether a December-January range of 5 to 7 per cent was consistent with the other specifications.

Chairman Burns noted that the Committee had a mechanism for dealing with inconsistencies that developed among the specifications in the inter-meeting period. He then asked Mr. Axilrod to comment.

Mr. Axilrod observed that if the projections were correct, the short-run ranges of tolerance for the aggregates suggested by the Chairman would imply a Federal funds rate within its proposed range, but below the 8-1/4 per cent midpoint.

Mr. Coldwell said Mr. Axilrod's comment suggested that the Desk would need to act promptly to lower the funds rate within the proposed range. In the event that subsequent developments suggested that the Desk should aim for a funds rate below 8 per cent, he hoped that the Chairman would consider consulting with the Committee before the Desk proceeded to do so.

A number of members expressed objections to Mr. Coldwell's suggestion, and the Chairman observed that a majority evidently did not favor it.

Mr. Mitchell remarked that he objected to the proposed 9-1/2 per cent upper limit for growth in M_2, because it would operate as a constraint in the event of a sizable reflow of consumer-type time and savings deposits to banks in the period ahead. He preferred an upper limit of 11 per cent, although he would accept one a little below that.

Mr. Holland said he agreed that the upper limit for the M_2 range was too low, and he also believed that the longer-run target for M_2 should be raised.

In response to a request by Mr. Mitchell, Chairman Burns asked the members to indicate their preference between 9-1/2 and 10-1/2 per cent for the upper limit of the M_2 range of tolerance over the December-January period.

The members' preferences were evenly divided between those two figures for the upper limit of the range.

The Chairman said he would recommend an upper limit of 10 per cent for the M_2 range. He then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and alternative B, as modified by Mr. Hayes, for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following specifications. The longer-run targets--namely, the annual rates of growth for the period from November 1974 to June 1975--would be 6, 9, and 6 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 9 to 11 per cent for RPD's, 5 to 7 per cent for M_1, and 7-1/2 to 10 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 7-1/2 to 9 per cent.

Messrs. Mitchell and Wallich indicated that they planned to dissent from the proposed directive.

With Messrs. Mitchell and Wallich 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 suggests that real output of goods and services is falling substantially further in the current quarter. Price and wage increases are continuing large, although not so large as earlier this year. In November declines in industrial production and employment were sharp and widespread, and the unemployment rate increased further, from 6.0 to 6.5 per cent. In recent weeks additional production cutbacks and layoffs have been announced. The November rise in wholesale prices of industrial commodities, although substantial, remained well below the extraordinarily rapid rate in the first 8 months of the year.

Since mid-November the dollar has declined somewhat further against leading foreign currencies. In October the U.S. foreign trade deficit was reduced sharply for the second consecutive month, while there were continued net inflows of bank-reported private capital and of investments by oil-exporting countries.

Growth of the narrowly defined money stock increased in November to an annual rate of about 7 per cent. Net inflows of consumer-type time and savings deposits remained strong at banks and continued to improve at nonbank thrift institutions, and the more broadly defined money supply measures again expanded appreciably. Bank loans increased only moderately. Most market interest rates, after rising in the second half of November, subsequently turned down again. Yields on State and local government securities, however, continued under upward pressure. Effective December 9, Federal Reserve discount rates were reduced from 8 to 7-3/4 per cent.

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 recessionary tendencies and encouraging resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat more rapid growth in monetary aggregates over the months ahead than has occurred in recent months.

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

It was agreed that the next meeting of the Committee would be held on January 21, 1975, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida
Secretary

ATTACHMENT A

Robert Solomon
December 11, 1974

Report on November Meetings of Working Party 3 and The Group of Ten Deputies

The Working Party examined the balance of payments prospects of OECD countries for 1975. For the OECD as a whole, the current account deficit in 1975 is expected to be roughly the same as in 1974, close to $40 billion, assuming the price of oil stays where it is. Rapidly rising OECD exports to OPEC countries will be offset by increasing OPEC interest earnings. In the latter part of 1975, however, the OECD current deficit is expected to begin to decline.

The distribution of the deficit among OECD countries raises problems. A disproportionate share of it ($15 billion) is projected to lie with the smaller OECD countries: Spain, Australia, New Zealand, the Scandinavian countries, Austria, Portugal, Greece and Turkey. Among the larger countries, Germany is expected to continue to have a substantial ($5 billion) current account surplus, though smaller than in 1974. The United States and Canada are expected to have larger current account deficits in 1975 while the positions of Japan, Italy and the United Kingdom improve. Although these changes for the larger countries are regarded as being in the right direction, they still leave an unsatisfactory distribution of the total OECD deficit.

The hope was expressed that more expansionary policies in the countries with relatively strong balance of payments positions, while those with weaker positions experienced a resultant increase in exports to the stronger countries, would improve the distribution of current account positions while also contributing to resumption of economic expansion in the OECD area as a whole. The possibility of some change in relative exchange rates was not ruled out.

As to the financing of current account deficits, the most vulnerable countries appeared to be reasonably confident about the next 6 months or so (this was before the Saudi Arabian decision not to accept sterling in payment for oil exports). They all have lines of credit that have not yet been drawn and the U.K. was receiving a substantial amount of OPEC funds. It was agreed that countries borrowing directly from OPEC countries should not provide indexed loans nor denominate their borrowings in the currencies of OPEC countries.

The decline in short term interest rates in the United States was cited as one explanation for the movement of the DM-dollar exchange rate, but no complaints were voiced about U.S. monetary policy.

The Deputies of the Group of Ten focused mainly on the Kissinger-Simon-van Lennep proposals for a backstop financing facility among the OECD countries to complement market channels and the IMF. The U.S. proposal was well received by the Deputies of most countries, with some hesitation by the German and Japanese representatives.

Most of the discussion concerned details of the plan. Among the issues are: 1) Should the facility be based on government to government lending through the BIS or on government guarantees that would permit the BIS to borrow in markets and lend to countries in need, or both? 2) How should quotas--for both borrowing and lending--be established and should borrowing rights and lending obligations be equal for each country? What conditions should be attached to use of the facility and how would its use be related to drawings on the Fund?

The Deputies established a working group to examine the technical aspects of the proposals. A report is expected in time for the January Ministerial Meetings of the Group of Ten and the IMF Interim Committee.

ATTACHMENT B

Henry C. Wallich
December 17, 1974

Report on BIS Meeting - December 9, 1974

The BIS meeting on December 9 covered an unusually wide range of topics.

The Eurocurrency Committee examined the BIS' current effort to collect more complete data on banking claims on developing countries, which is going forward satisfactorily, and the assembly of information on regulatory and supervisory practices, which has been virtually completed. Some dissatisfaction was voiced with delays in the collection and dissemination of Eurocurrency data. Attention was drawn to the interest of the International Monetary Fund in entering this field, and suggestions were made for expediting data handling at the BIS.

The governors' meeting discussed and adopted a proposal for the creation of a new staff committee to deal with problems in the area of bank liquidity, solvency, and related matters. Each central bank would nominate two staff representatives, one for regulation and supervision and one for data gathering, who would meet from time to time under the chairmanship of George Blunden of the Bank of England. Exchange of information, rather than harmonization of national practices is to be the objective. The new group would parallel in some respects, but not compete with or supersede, the committee of regulators and supervisors of EEC countries now functioning under the chairmanship of Albert Dondelinger of Luxembourg. Governors Mitchell and Wallich talked to Mr. Dondelinger and sought to make arrangements to bring his group to Washington for an exchange of views some time early next year.

Governor Richardson said that he was contemplating a letter addressed to the London banks on the subject of their foreign exchange operations.

Governor Mitchell discussed the structure of U.S. bank regulation and supervision, making clear the diversity of arrangements and by implication, the difficulty of any coordination with procedures abroad. He also described the foreign banking legislation put forward by the Federal Reserve Board, indicating that it had had a good Congressional and public reception. There were no adverse comments.

There was a brief discussion of U.S. gold legislation and Treasury activities with respect thereto. In setting these forth, Governor Wallich broadly followed the testimony of Chairman Burns before the Gonzalez subcommittee on December 5, without taking a pronouncedly negative attitude toward U.S. policy or raising the specter of possibly alarming consequences. Very few questions were asked.

The most interesting discussion concerned the recent announcement of the German Bundesbank that they would expand the monetary base at a rate of 8 per cent for the next year. The purpose of this policy announcement was stated to be to give the government, labor, and business a fixed frame of reference for their planning with respect to wage and price setting and financing. Dr. Emminger explained the derivation of the growth rate of the monetary base, which makes allowance for foreseeable rates of inflation, real growth, and changes in the relation of the base of the money supply and the money supply to GNP. The base was chosen in preference to M_1 because M_1 in Germany has proved to be less stably related to GNP than the base.

In the discussion, questions were raised concerning the ability of the Bundesbank to stick to its targets, the possible effects of a rigid limitation of base growth upon the ability to intervene in exchange markets to keep the mark from rising, and the effect on interest rates. It was noted that, for a country with a large international sector like Germany, the new policy seemed to give a remarkably high priority to domestic considerations. A somewhat extreme formulation of the policy, not by a German representative, was that the Bundesbank was telling the labor unions what nominal GNP was going to be and was leaving it to them how they wanted to split it between price increases and real increases.

ATTACHMENT C

December 16, 1974

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on December 16-17, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services is falling substantially further in the current quarter. Price and wage increases are continuing large, although not so large as earlier this year. In November declines in industrial production and employment were sharp and widespread, and the unemployment rate increased further, from 6.0 to 6.5 per cent. In recent weeks additional production cutbacks and layoffs have been announced. The November rise in wholesale prices of industrial commodities, although substantial, remained well below the extraordinarily rapid rate in the first 8 months of the year.

Since mid-November the dollar has declined somewhat further against leading foreign currencies. In October the U.S. foreign trade deficit was reduced sharply for the second consecutive month, while there were continued net inflows of bank-reported private capital and of investments by oil-exporting countries.

Growth of the narrowly defined money stock increased in November to an annual rate of about 7 per cent. Net inflows of consumer-type time and savings deposits remained strong at banks and continued to improve at nonbank thrift institutions, and the more broadly defined money supply measures again expanded appreciably. Bank loans increased only moderately. Most market interest rates, after rising in the second half of November, subsequently turned down again. Yields on State and local government securities, however, continued under upward pressure. Effective December 9, Federal Reserve discount rates were reduced from 8 to 7-3/4 per cent.

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 recessionary tendencies and encouraging resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with more rapid growth in monetary aggregates over the months ahead.

Alternative B

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat more rapid growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Alternative D

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with relatively slow growth in monetary aggregates over the months ahead.

ATTACHMENT D

December 17, 1974

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 12/17/74)
A. Longer-run targets (SAAR): (December plus first and second quarters, combined)	M_1	6%
	M_2	9%
	Proxy	6%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (December-January average):		9 to 11%
2. Ranges of tolerance for monetary aggregates (December-January average):	M_1	5 to 7%
	M_2	7-1/2 to 10%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		7-1/2 to 9%
4. Federal funds rate to be moved in an orderly way within range of toleration.		
5. Other considerations: account to be taken of developments in domestic and international financial markets.		

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.