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, October 14-15, 1974, beginning at 5:30 p.m. on Monday.

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

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

Mr. Eastburn, President of the Federal Reserve Bank of Philadelphia

Mr. Broida, Secretary
Mr. O'Connell, General Counsel

Messrs. Leonard and Williams, First Vice Presidents of the Federal Reserve Banks of St. Louis and San Francisco, respectively

Chairman Burns noted that this was the last meeting of the Committee Mr. Coldwell would attend in his capacity as President of the Federal Reserve Bank of Dallas. As the members knew, Mr. Coldwell had been nominated by President Ford to fill a vacancy on the Board of Governors, and the nomination had been approved by the Senate last week. Accordingly, he would be attending future meetings of the Committee in a different capacity.

The Chairman then observed that he had called for this executive session for the purpose of discussing a number of matters, including that of staff attendance during the Committee policy deliberations. Board members and Reserve Bank Presidents had discussed that and related subjects in a meeting on September 11, and while he had had to leave before the conclusion of that meeting, he had before him Mr. Holland's memorandum[1/] summarizing a consensus that had emerged. He concurred in some but not all of the points listed in the memorandum.

1/ A copy of this memorandum, entitled "Meeting of Board Members and Federal Reserve Bank Presidents September 11, 1974," has been placed in the Committee's files.

After some further comments, the Chairman remarked that it would be inefficient for the Committee as a whole to spend the time needed to deliberate on certain of these procedural matters. Accordingly, he would appoint a Subcommittee for the purpose, consisting of Messrs. Hayes, Black, Coldwell, and Mitchell, with Mr. Mitchell as chairman. Mr. Partee would serve as staff adviser to the subcommittee.

Chairman Burns then said that in the time remaining today he would summarize developments at the meeting of Foreign Ministers and Finance Ministers of five leading industrial countries that had been held in Washington during the weekend preceding the Bank-Fund meetings for the purpose of discussing the oil problem. The Committee might then consider some aspects of the economic program the President had announced on October 8.

Following discussion of these matters, the meeting recessed until 9:30 a.m. the following morning, Tuesday, October 15, 1974. In addition to those present on Monday afternoon, the following staff members were present:

Mr. Altmann, Deputy Secretary
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. R. Solomon, Economist (International Finance)
Messrs. Brandt, Bryant, Doll, Hocter, Pierce, and Reynolds, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Wonnacott, Associate Director, Division of International Finance, Board of Governors
Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Miss Pruitt, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Eisenmenger, Boehne, and Scheld, Senior Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and Chicago, respectively
Mr. Garvy, Vice President and Senior Adviser, Federal Reserve Bank of New York
Messrs. Snellings, Jordan, and Green, Vice Presidents, Federal Reserve Banks of Richmond, 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
Mr. Sandberg, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the Committee ratified the action of members on September 25, 1974, authorizing and directing the Federal Reserve Bank of New York, under the provisions of 270.4(e) of the Regulation relating to Open Market Operations of Federal Reserve Banks, to engage in such open market transactions in foreign currencies, including transactions for the System Open Market Account, as may be necessary to carry out the arrangements that have been made by the Federal Reserve Bank of New York, with the concurrence of the Board of Governors of the Federal Reserve System, for the disposition of assets and liabilities of the Franklin National Bank.

Mr. Sheehan observed that in his opinion the New York Bank's handling of the Franklin National Bank problem had been splendid.

Chairman Burns remarked that the Franklin National Bank matter was one of the most difficult that the Federal Reserve had ever had to deal with and that the System as a whole was greatly indebted to Messrs. Hayes and Debs and their colleagues at the New York Bank. Also, Frank Wille, Chairman of the Federal Deposit Insurance Corporation, had dealt with his part of the problem with great skill and fine spirit throughout the difficult period of the Franklin National Bank problem.

Mr. Hayes commented that he and his colleagues at the New York Bank appreciated the team work that they had enjoyed with the Board of Governors and its staff.

Mr. Holland remarked that Mr. Coombs also deserved the compliments of the Committee for the manner in which he had untangled the difficult technical problems involved in Franklin's foreign exchange book.

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee held on August 20 and September 10, 1974, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee held on August 20 and September 10, 1974, were 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 September 10 through October 9, 1974, and a supplemental report covering the period October 10 and 11, 1974. 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 the last Committee meeting the dollar was showing considerable strength against the mark and other European currencies. In the absence of sizable sales of dollars and other foreign exchange by the German Federal Bank, the dollar would probably have risen appreciably above its central rate against the mark. The dollar remained buoyant until late September, when confidence suddenly began to weaken. The weakening seemed to reflect market fears that recessionary tendencies in the United States were gathering momentum and might compel a major easing of credit policy that would tend to divert international flows of funds from the dollar markets to European centers where interest rates would come down more slowly. The IMF meeting in Washington provided a great deal of grist for the rumor mills. Even more disquieting, we began to get reports early in October of renewed diversification moves by the oil-producing countries, involving shifts out of both sterling and dollars into marks and other European currencies.

As the dollar slipped back against the mark, we began on October 2 to resist the decline, and by October 4 had sold $36 million of marks from balances. Then on October 9--last Wednesday--an adverse market reaction to President Ford's economic message plus further diversification of petrodollars pushed the dollar down sharply in European trading before the New York opening. As selling pressure on the dollar continued after the New York opening, the German Federal Bank urged us to intervene forcefully and promised to reinforce our operations in Frankfurt the next day. Accordingly, we sold the remaining $26 million of our balances and a further $78 million worth of marks financed by new drawings on the swap line, for a total intervention last Wednesday of $104 million worth of marks. Then on the following day, Thursday, the German Federal Bank intervened even more forcefully to buy $186 million, and we followed up in New York with another $15 million. On last Friday and yesterday the market turned somewhat more quiet, but today new pressures on the dollar have led the German Federal Bank to spend another $30 million in support operations. And again there are reports of oil money moving out of both sterling and dollars into marks and other Continental currencies. At the present moment we have an offer of marks out in New York, 15 million marks, in order to try to provide some resistance to a further rate decline.

As for the Franklin foreign exchange book, we took over contracts totalling $724 million and so far have settled $86 million, leaving $638 million to go. All of the contracts have been confirmed, and we shall be able to bridge all of the maturity gaps in the book by short-term swaps with foreign central banks. Our major remaining problem is with two Italian institutions belonging to the Sindona group which are now in receivership. The Bank of Italy has assured us that our contracts with these institutions will be honored, but we are presently trying to resolve the question of whether they will settle in the foreign currencies specified or, instead, will pay us the net amount due in dollars. When this issue is settled, the rest of the operation should proceed in a fairly routine way. We continue to anticipate that there will be no losses to the Federal Reserve.

Chairman Burns asked Mr. Coombs to explain how swaps with foreign central banks were used to bridge maturity gaps in Franklin's foreign exchange book, and he asked how long a period would be required to complete the operation.

In response, Mr. Coombs said the Franklin book might, for example, indicate that a payment of $10 million worth of French francs was to be made on January 10 while balancing receipts of francs were not due until 20 days later. The francs required for the payment on January 10 would be obtained by drawing on the swap line with the Bank of France, and 20 days later the incoming receipts of francs would be used to reverse the swap. The swap drawing itself was on a flat basis, involving no cost to the System, and the only interest involved was the amount that the Bank of France earned for the 20 days during which it held the dollar counterpart of the swap. With respect to the time period, the operation would not be completed until August, but the bulk of the contracts would be fulfilled by the end of March.

The Chairman then asked whether recent disturbances in the foreign exchange markets had been caused by shifts of OPEC funds, whether information was available on the amount of such shifts, and what might be the best means of dealing with them. So far, apparently, shifts had been small, but potential movements were quite large.

Mr. Coombs replied that shifts of OPEC funds were one of the causes of the recent disturbances. The information available on the amounts involved was limited, because foreign exchange dealers, understandably, were very reluctant to reveal customers' names. However, frequent reports were being obtained from London, and it was apparent that OPEC funds were being moved out of sterling as well as out of the dollar. Managers of petrodollars might have been led to move funds by a $700 million equivalent issue of notes by the German Finance Ministry. Through some misunderstanding, the German commercial banks had sold a large amount of the notes to foreigners, including Arab countries. After the German Federal Bank involved itself in the situation, the sale of notes was suspended, but some managers of OPEC funds nevertheless gained the impression that Germany might welcome inflows of such funds.

Concerning the problems caused by the flows, Mr. Coombs remarked that for some time he, like the Chairman, had regarded the situation as essentially unmanageable. Over time, such shifts in funds from one currency to another would create increasing difficulties. However, it was necessary to intervene in the markets in an effort to maintain orderly conditions and to resist a sudden decline in a currency's value.

Mr. Eastburn asked whether it was realistic to assume that the kind of speculation in foreign exchange that had led to the problems of the Franklin National Bank and to those of the Herstatt Bank and the Banque du Bruxelles was no longer being engaged in.

Mr. Coombs replied that it was not unlikely that such speculation was continuing. It was true that the losses suffered by those banks had had a chastening effect on some traders, but the losses had counterparts in the profits that accrued to other institutions, and the profits might well provide a temptation to continue speculating.

Mr. Holland said Mr. Coombs' remarks seemed to imply that it was desirable to continue intervening in the market for the purpose of resisting unduly sharp movements in rates against the dollar but that it was also desirable to avoid cumulating substantial swap drawings in trying to deal with the existing fundamental disequilibrium. He asked whether Mr. Coombs agreed.

Mr. Coombs replied that the amount of funds that could be shifted from one currency to another was so large that it probably would not be possible to resist sharp movements in rates against the dollar without substantial drawings on the swap lines. In the circumstances, $100 to $150 million of market intervention might be required.

Chairman Burns remarked that such a market environment raised the question of whether intervention should be held to a small scale and movements in rates allowed to occur.

In response, Mr. Coombs said the consequences of reducing the scale of intervention and allowing the rates to move down sharply would be very painful. At the same time, however, it was important to avoid supporting the dollar at an unduly high level. In his view, more attention should be paid to the exchange rates at which the System intervened in the market--and to the rates at which swap drawings were made and repaid--than to the over-all volume of intervention. In the recent period of intervention to support the dollar against the German mark, for example, the System's balances of marks had been sold at rates that resulted in profits of nearly $1.2 million. Moreover, recent swap drawings, on the average, had been made at a rate about 4 per cent below the dollar-mark central rate. As time went on, the oil-exporting countries would find it difficult to place much of their funds outside the United States. Consequently, the long-term trend was favorable to the United States, and it would be a pity to allow current shifts of $100 million or so out of dollars--as oil-producing countries achieved some diversification--to depress the exchange rate for the dollar.

Chairman Burns, noting Mr. Coombs' judgment that the longer-term trend was favorable to the United States, asked why it was necessary to intervene to any considerable extent and whether minor fluctuations in the exchange rate were of much importance.

Mr. Coombs observed that at times, as in the early part of this year, the rate for the dollar had declined sharply; that it could do so again; and that such declines might have a major inflationary impact on the price level. In his judgment, it was a good strategy to allow the rate to drop about 4 or 5 per cent--at which point swap drawings could be made at reasonably favorable rates--and then to attempt to resist further declines.

Mr. Holland commented that he was troubled by the prospect that the System would incur a large cumulative debt on the German swap line by drawing large amounts of marks periodically to defend the dollar and by not repaying the drawings during the intervening periods between attacks because the dollar had not recovered enough or because repayment would entail some further decline in the rate. It seemed to him that it would be unwise to use the swap lines to support the dollar over the time span that might be required for everyone to come to the understanding that petrodollars would be placed in this country and that the dollar, consequently, would be strengthened against other currencies in general.

In response, Mr. Coombs said he agreed that swap drawings should not be allowed to cumulate, and over the past year, the System had moved quickly--sometimes over protests from the Treasury--to buy the marks needed to repay drawings. With respect to the underlying strength of the dollar, he thought it was already apparent. Occasionally, however, the market was disturbed by some development, such as the recent German issue of notes available for purchase by foreigners, the effort of oil-producing countries to achieve some diversification, and possibly some misinterpretation of the degree of easing in monetary policy in this country. Such short-term developments were more or less manageable. He was more concerned about developments over the next 1 to 3 years, when the cumulation of oil funds could lead to some shifts having a certain sinister quality.

Mr. Holland remarked that he applauded the manner in which each drawing so far this year had been repaid in a short period of time.

In reply to a question by Mr. Black, Mr. Coombs observed that while he anticipated that the System would not incur any losses in fulfilling the foreign exchange contracts taken over from the Franklin National Bank, there would be the interest cost of the swap drawings made to bridge maturity gaps.

Chairman Burns commented that the Federal Reserve might incur some losses in connection with the Franklin matter, but the System's action in taking over Franklin's foreign exchange contracts was an extraordinary example of the purposeful discharge of a central bank's responsibility for the stability of the financial system. It was an example that might well be followed by central banks elsewhere. In this country, reactions in the financial community had been highly favorable to the action.

> By unanimous vote, the System open market transactions in foreign currencies during the period September 10 through October 14, 1974, were approved, ratified, and confirmed.

Chairman Burns noted that a memorandum from Messrs. Hayes, Mitchell, and Wallich, dated October 11, 1974, and entitled "Considerations underlying a Subcommittee decision regarding repayment of Belgian franc swap debt," had been distributed to the Committee.[1/] He asked Mr. Mitchell to comment.

Mr. Mitchell noted that, as indicated in the Subcommittee's memorandum, the members agreed that the swap debt ought to be settled as expeditiously as possible, that proposing to the U.S. Treasury at this time that SDR's be used if necessary might cause protracted discussions with Treasury officials and thus delay rather than expedite settlement of the debt, and that, at least for the time being, the proposal should not be made. However, the members differed as to whether Treasury participation could be avoided: Mr. Hayes thought it could not be, Mr. Wallich thought it could be, and he (Mr. Mitchell) was undecided. He then asked Mr. Coombs whether there had been any further developments.

Mr. Coombs replied that to his knowledge the Belgian Minister of Finance had not yet replied to the Treasury's communication of September 25, inquiring whether Belgium was prepared to accept an equal sharing of profits and losses on the swap debt.

Chairman Burns asked whether Mr. Coombs had any advice to give to the Committee with respect to the Belgian debt.

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

Mr. Coombs observed that repayment of the debt would be stalled until the Belgians replied to the proposal for equal sharing of profits and losses. Should they reject the proposal, the System would have a case for purchasing the francs in the market, accepting additional losses of 3 or 4 per cent. However, the Belgians probably would object to any sizable amount of market purchases, and they would have the support of their partners in the European Community snake; the Belgian franc was close to the ceiling of the snake band, and if System purchases were to push the franc to the ceiling, one or more of the other countries would lose reserves in conducting support operations. It was for that reason that he had contemplated a request for Treasury assistance, in accordance with the terms of a 1968 letter from Treasury Secretary Fowler to Chairman Martin. The use of SDR's was one means of such assistance. The Treasury might prefer, alternatively, to sell to the Belgians a bond denominated in Belgian francs for the purpose of acquiring the currency with which to repay the swap debt. Such instruments had been used on a number of occasions in the 1960's.

Mr. Mitchell commented that, while he would wait for the Belgians' response to the Treasury communication, he believed that the debt ought to be cleaned up. If acquisition of francs through market purchases could only be accomplished over a relatively long period, he would be inclined to seek Treasury assistance in some form.

Chairman Burns remarked that he agreed with Mr. Mitchell.

Mr. Holland observed that--taking account of much of Mr. Coombs' views--he would propose a program that he believed would terminate the debt in a responsible way. First, Mr. Coombs should communicate with the National Bank of Belgium immediately and then again at frequent intervals in order to press them for a reply to the question of profit and loss sharing. Because it was a difficult question for them, the Belgians might be inclined to delay action.

Chairman Burns commented that Mr. Coombs might raise the issue with the Belgians at 3-week intervals.

Mr. Coombs said he would contact the Belgians on the following day.

Continuing, Mr. Holland remarked that should the Belgians respond with anything less than an unequivocal agreement to the loss-sharing arrangement, the System should make known to the U.S. Treasury its willingness to assume all losses in cleaning up past debt while leaving open for future consideration the sharing of profits and losses on future drawings. In that connection, the System might advise the Treasury that while the loss was not large, it was larger than it would have been had the System repaid the debt a year ago, as it had wished to do, instead of delaying in accordance with the Treasury's wishes. Third, the System should inform the Belgians of its desire to make progress in repaying the debt and should negotiate with them about the acceptable amount of periodic System purchases of francs in the market. Even purchases of no more than $100,000 worth of francs a week would permit progress in reducing the debt, and making some progress was important. Finally, even while buying Belgian francs in the market, the System should press the Treasury to consider funding the debt with a bond denominated in Belgian francs or using SDR's to repay it. It was important to clean up that debt. And the System should endeavor to heighten the Treasury's awareness that central bank debt ought to be treated differently than government-to-government debt.

Mr. Wallich remarked that Mr. Holland's program was a plausible way of proceeding to clean up the debt, and it would be better to incur a loss in acquiring the necessary francs than to allow the debt to continue indefinitely. However, he would not wish to seek Treasury assistance with respect to any future debts, because the Treasury, if asked to bear the ultimate responsibility associated with intervention in the foreign exchange market, might take the position that it ought to control those operations. Also, he would not favor the use of SDR's; he preferred the use of a bond denominated in Belgian francs.

Mr. Coombs commented that from the inception of the swap network it had been understood that drawings were short-term and that the Treasury would assist, if necessary, in repaying them. On many occasions the Treasury had done so by selling gold. Treasury involvement in repayment of the Belgian debt, through use of a bond or SDR's, would permit acquisition of the required francs at current market rates, but it would not shift any of the loss from the System to the Treasury.

In reply to a question by Mr. Mayo, Mr. Coombs said the major part of the loss, amounting to something over $50 million of the total, would be incurred in the process of writing up the debt to take account of the two devaluations of the dollar. The remainder of the loss would depend on market rates of exchange at the time of acquisition of the francs; it would amount to 3 to 4 per cent on the written-up total of $320 million.

Chairman Burns observed that the essence of the matter, as he saw it, was that the System ought not to maintain an open speculative position for an extended period; swap drawings should be short-term debts. It was likely that other countries soon would be drawing on the swap lines, and the System should be in a position to enforce repayment within a short period--if not within 3 months, certainly within a year. The System's ability to do that would be undermined if it dragged its own repayments out over a period of years.

Mr. Wallich remarked that he agreed with what the Chairman had just said--which was the main reason for taking steps now to repay the Belgian debt--except that he was concerned about the reference to a speculative position. After all, Germany held some $30 billion in reserves, and perhaps one could characterize that as a speculative position. However, it was a fact of life that a reserve position--positive or negative--in a period of floating exchange rates entailed a risk of loss. Both Germany and Japan had experienced enormous losses on their holdings of foreign exchange when they had allowed their currencies to appreciate against the dollar. He feared that if a great deal of emphasis were given to avoiding losses, the United States would be deprived of a useful instrument in the international system. If the United States could not hold balances or incur debt in foreign currencies for purposes of intervention in the foreign exchange market, it would once again become a passive factor and the exchange rate for the dollar would be determined by the market intervention of other countries.

Chairman Burns remarked that he had not intended to suggest that the risks of loss should not be incurred for the purposes indicated by Mr. Wallich. In making his earlier remarks, he had been concerned primarily with prospective drawings by other countries and with the System's ability to hold foreign central banks to repayment within a year.

Mr. Hayes commented that he recognized the importance of Mr. Wallich's concern that dependence on Treasury assistance in repaying swap debts might strengthen Treasury's wish to share in the making of decisions at earlier stages, but some degree of Treasury participation or acquiesence had always been recognized in connection with swap drawings. It was significant, also, that over the years most swap drawings had been repaid without Treasury participation, and one could expect that most drawings in the future would be self-liquidating.

Chairman Burns observed that it was evident from the discussion that the Committee was eager to repay the Belgian debt as expeditiously as possible.

Mr. Coombs then noted that a swap drawing of $180 million by the Bank of Mexico would mature soon. As the members might recall, the Bank had given firm assurances when making the drawing last August that it would repay by the first maturity, and recently the Governor of the Bank had reaffirmed the intention to do so.

Mr. Coombs noted, in addition, that a number of swap drawings dating back to 1971 would mature for the thirteenth time soon. They included the 6 drawings on the National Bank of Belgium, totaling $230 million, which matured in the period from November 4 through November 14, and two Swiss franc drawings --one of $600 million on the Bank for International Settlements and one of $371.2 million on the Swiss National Bank--which matured on November 14 and 15, respectively. While there was a possibility of repaying some or all of those drawings before maturity, that was not assured and he would recommend that the Committee authorize their renewal if necessary. Since the swap lines in question had been in continuous use for more than one year, express authorization was required for renewal under the provisions of paragraph 1(D) of the Authorization for Foreign Currency Operations.

In response to a question by Chairman Burns, Mr. Coombs observed that the easiest and best way to repay the outstanding drawings in Swiss francs would involve acquisition of the necessary francs through issuance by the U.S. Treasury of a bond denominated in Swiss francs. The Treasury already had $1.6 billion of such bonds outstanding. Another method involved the use of SDR's, which the Swiss probably could accept. However, the Treasury was more likely to agree to the issuance of a bond. Alternatively, the debt could be reduced in small increments through market purchases of francs. In that connection, one disadvantage of the 50-50 loss sharing agreement was that it gave the other party an opportunity to object to purchases in the market more vigorously than if it had to bear no share of the loss.

By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, the Swiss National Bank, and the Bank for International Settlements, maturing in the period November 4 through 15, 1974, was authorized.

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

Mr. Partee made the following statement:

Evidence of current and prospective weakness in the economy has accumulated over the past month or two, and there now appears to be a rather widespread expectation among businessmen, investors, and consumers that the recession will deepen. It is not that there have been no optimistic notes; industrial production rose a little in September, the substantially smaller increase in wholesale prices last month was heartening, and the very recent rally in stock market prices has been a relief, to say the least. But gloom about the economy is the prevailing mood; unemployment, underlined by the sharp September increase, is generally expected to rise substantially further, while labor costs and prices are expected to continue climbing at a fast pace.

Partly reflecting this pessimistic sentiment, consumer buying has tended to weaken further in recent weeks. There was a spurt in new car sales during the summer, reflecting the buying of 1974 models in anticipation of higher prices and less desirable features for the 1975 model year, but recently sales have faded again as the supply of the 1974's is being exhausted. Sales of furniture and major appliances have weakened dramatically over the last 2 months, and purchases of color TV sets also have dropped sharply. The latest consumer surveys, moreover, show substantial softness in buying plans for the period ahead. With prices continuing to rise at a relatively fast pace, we would not expect to see much strength in consumer buying until at least next summer.

The sluggishness of demand at the consumer level, in turn, appears to be contributing to a marked change in business inventory attitudes. Inventories at retail are said by many to be excessive, not only in durable goods but also in some nondurable lines, such as textiles and apparel. Manufacturers' attitudes toward inventory positions appear to be changing too, as the list of industrial materials in short supply narrows and there is more uncertainty about future price trends. Our index of sensitive materials prices has now dropped 18 per cent from its April high, while the factory utilization rate for major industrial materials is estimated to have dropped further, to 87 per cent in September. Our staff projection still assumes positive inventory investment through 1975, but at a very moderate, and declining, pace.

There has also been more questioning than before about the strength of the outlook for business capital spending. We continue to project substantial further growth over the next year in dollar terms, and a small further rise in real outlays, because order backlogs remain so large and needs for additional capacity in many strategic industries are so pressing. But there is no denying that the tendency is toward cutbacks and stretchouts. The list we have been keeping since spring now shows a net reduction of nearly $15 billion in previously announced capital spending plans, mostly by the utilities and mainly applicable to 1975 and later years. And the confidential Lionel Edie survey of capital spending plans for 1975 shows a rather disappointing increase of only 10 per cent in dollar outlays, with considerable strength in manufacturing offset in part by weakness in spending on commercial facilities.

Of all of the major sectors of the economy, the outlook is most bleak--at least for the near-term--in housing. Starts dropped to 1.1 million units in August, as you know, with permits even lower, at an annual rate of only 900,000. But the real problem, I fear, is the financial condition of the builders. Completed property has not sold at all well. The inventory of unsold houses offered by merchant builders at the end of August amounted to an 11-month supply, and the overhang of condominium apartments and office space also is reported to be very heavy. The carrying cost of this inventory, plus the raw land that had been purchased earlier for future development, is exceedingly high. Many builders say that the problem is no longer production, which they have long since given up, but orderly retrenchment and survival. Under the circumstances, the flow of credit to this industry--which must include construction financing as well as permanent mortgages--may be very slow to revive.

In sum, we have seen nothing in the current evidence that would lead us to strengthen our economic projection. Indeed, we have cut back the projection of the near-term outlook as compared with 5 weeks ago, reflecting mainly weaker housing starts and, in the third quarter, lower inventory accumulation and net exports than had been expected earlier. Real GNP is now projected to decline 2 per cent from mid-1974 to mid-1975, before commencing a very modest recovery. The unemployment rate is expected to rise to 7 per cent by the second quarter of next year, and then to increase somewhat further during the second half as the projected economic recovery is insufficient to lift employment in line with the growing labor force. Let me emphasize that this projection does not allow for any over-all inventory liquidation or for significant weakening in real capital spending, both of which conceivably could develop.

Despite this exceedingly bleak outlook, we do not see the basis for expecting any quick reduction in the rate of inflation. We anticipate that the over-all rate of price increase will fall back by early next year to the one-digit level, but that it will then hold at a relatively high--though declining--pace throughout the year. The problem is that the increase in wage rates is likely to remain in the 9 to 10 per cent range, in view of the insistent demands of both organized and unorganized workers for cost of living compensation, and that weakness in over-all output is unlikely to be accompanied by sizable productivity gains. Even with lower materials prices, and some narrowing in profit margins, the cost-push effect on prices will be strong. I would note also that our price projection depends on reasonably moderate increases in food prices which, with the recent further deterioration in food production prospects, may be an overly optimistic assumption.

The problem of policy, therefore, remains as it has been before. The outlook for real economic activity is weak--too weak to be sustained for long without serious economic dislocations and unacceptable material and social costs. But the outlook for inflation also remains distressingly poor; the rate of price increase, though probably declining, is likely to remain too high to tolerate for long. It does seem clear, however, that the additional weakness that appears now to be developing in the economy is counter-productive. It will create strong demands for remedial action but will serve little purpose in further dampening inflationary forces. Some moderate easing up in restraint would probably improve the performance of the real economy in 1975, and it might help to avert the worst of the financial problems for the housing industry and for other sectors that have been most seriously affected by the high cost and limited supply of credit this year.

Mr. MacLaury commented that his view of the economic outlook was similar to Mr. Partee's. According to press reports, the Wharton School had incorporated the features of the President's program into its projections and had found them to have a slightly negative impact on over-all activity. His own staff's assessment was the the program would have no significant effect on over-all economic activity. He asked whether the Board staff had appraised the program.

Mr. Partee replied that, as the listing in the supplement to the green book[1] indicated, many of the stimulative features of the President's program had already been reflected in staff projections. Specifically, the staff had assumed total Federal budget outlays of just under $300 billion in fiscal year 1975; an expanded public employment program that was somewhat larger than that recommended by the President; extended unemployment benefits; and additional funds for housing credit. The tax proposals in the program had not been reflected in the projections, and on balance, they would increase Government revenues. Taking account of the tax proposals, therefore, would weaken the projections of economic activity.

Mr. Mitchell remarked that projections made by econometric models had the advantage of being internally consistent, but the models had no historical precedent for the present situation. He asked Mr. Partee for his personal view of the economic outlook for 1975.

In response, Mr. Partee observed that, in making its projections, the staff was not bound by the econometric model.

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

The staff presented a judgmental projection, which of necessity followed a middle course, taking into account the behavior of the model, other kinds of evidence, and the judgments of various senior staff members. The recent record of staff projections of real GNP, but not of projections of prices and nominal GNP, had been better than that of most other forecasts. For quite a few months, the staff had been projecting the current weakness in activity.

With respect to his personal view, Mr. Partee continued, he believed that the economy was a good deal weaker than indicated by the latest staff projections. The probability seemed fairly high that a liquidation of inventories was developing. If it developed, it would depress output in the period immediately ahead even more than indicated by the projections, although the subsequent upturn might also be somewhat stronger. Business capital investment plans also were likely to weaken considerably through the autumn and winter, as corporate managements reevaluated their weakening market prospects and took account of higher capital costs. And, finally, financial problems probably would be more severe than any encountered since the second world war. Altogether, the economic outlook was rather grim.

Mr. Morris commented that he, like Mr. Partee, foresaw more weakness in economic activity than suggested by the staff projections. Assuming that the Committee's objective for monetary policy was to contribute toward a course of economic activity that would gradually reduce the rate of inflation over the next few years, he questioned whether more slack in the economy would be generated in 1975--even in the staff projections--than the American people would be willing to accept for any length of time in the interest of dampening inflation.

In response, Mr. Partee noted that staff projections suggested that next year the unemployment rate would rise in each quarter and would average 7 per cent; that housing starts would total only 1.25 million; and that automobile sales, including imports, would be only about 9 million units. That performance implied more slack than was necessary to put the economy on a less inflationary path. In his view, moreover, it was not sustainable; before the year was over, Government action would be taken to reduce unemployment and restimulate the economy.

Mr. Partee added that the recovery, when it came, should not be so vigorous that economic activity rose from well below the desired path in 1975 to above it as 1976 progressed--as, it might be argued, activity did in the 1972 recovery. Therefore, while some stimulus to the economy was needed, a sharp change in policy should be avoided. Such a change would run the risk of regenerating inflationary expectations and speculative buying, thereby stimulating too rapid an advance in activity in late 1975. Policy actions taken to influence the course of economic activity in 1975 had to be viewed, also, in terms of their effects on developments in 1976.

In response to a question by Mr. Mayo, Mr. Partee said he would assume that a change in the withholding schedule for personal income taxes would be part of the Administration's recommendations to the Congress. The surcharge on corporate income taxes would affect quarterly declarations.

Mr. Mayo remarked that his view of the economic outlook now, in contrast with 5 weeks earlier, was as pessimistic as Mr. Partee's. In his District, there was evidence that shortages were being eliminated more rapidly than had been expected, and delivery delays were fewer. Especially discouraging was the outlook for food prices; his staff had estimated that, because of the poor crops this year, food prices might rise as much as 14 per cent by early 1975, contributing 3 to 4 percentage points to the rise in the total consumer price index.

Mr. Partee commented that the staff projections of prices had not taken into account the further deterioration in crop conditions recently reported by the Department of Agriculture. Higher prices for corn and soybeans affected prospects for supplies and prices of pork, poultry, eggs, milk, and vegetable oils in 1975.

Chairman Burns remarked that the price outlook for the affected foods was clouded by present uncertainties concerning export policies for foodstuffs.

Mr. Eastburn, noting that staff projections of economic activity for the second half of 1974 and the first half of 1975 had undergone successive downward adjustments, asked how confident the staff was of an upturn in the economy during the second half of 1975.

Mr. Partee replied that he thought an upturn in the second half was likely. That expectation was based on two major elements. Residential construction activity was expected to turn up in response to the declines in interest rates and improved availability of credit associated with the lower projected levels of over-all economic activity, and he believed that the chances for a turnaround in housing were good. Second, it was assumed that real consumer incomes would be increasing by then, as the rise in wage rates exceeded that in consumer prices. It seemed reasonable that in the environment of the period ahead, prices of some industrial materials would be declining and profit margins would be squeezed. It was possible, of course, that the gains in real income for those remaining employed would be offset in the total by declines in the number of persons employed. Finally, if inventory liquidation occurred in the first half, its depressing effect on total real GNP might be over by midyear and a second-half upturn would be even more likely.

Mr. Leonard commented that the September increase in the unemployment rate from 5.4 to 5.8 per cent was discouraging. Although the major part of the increase was among female and teenage workers, unemployment had also risen for household heads and married men. However, it seemed to him that it was important to look beyond the unemployment figures. Total civilian employment rose at an annual rate of 5 per cent in September; from April to September, the rise was at a 2 per cent annual rate, or about double the long-term rate of increase in the population. The statistics suggested that the increase in the rate of participation in the labor force was among women and teenagers. That was not hard to understand; it reflected the desire to maintain family income in the face of rapid inflation. The statistics also suggested that participation rates for married men and heads of households had fallen, and he thought that to some extent the rise in the rate of unemployment of those key labor force groups might reflect decreases in their participation rates and in the number employed rather than a rise in the actual number of unemployed.

In response, Mr. Partee said the substantial increase in total civilian employment in September followed a decline in August; over the 2 months, employment expanded at the relatively modest annual rate of 1.2 million persons. Total employment in nonfarm establishments, which the staff had long viewed as a more reliable indicator of short-run movements, changed little over the 4 months from May to September. Perhaps of even greater significance, the number of production workers on manufacturing payrolls declined in each month from June to September; in the past such a decline often had been followed by a more general contraction in employment and economic activity. It was noteworthy, also, that initial claims for unemployment insurance had risen sharply from early September--when the last household survey of employment was made--to early October, and initial claims were more than 50 per cent above the level of a year earlier.

Mr. Sheehan remarked that in recent months the St. Louis Bank had been more optimistic about the economic situation and outlook than he had been. The latest red book[1/] review of developments in the Eighth District called attention to a generally high level of employment and to other indications of strength. Recently, however, General Electric had laid off a sizable number of workers

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

at its Louisville plant, and he asked if other such pockets of weakness might be developing in the District.

In response, Mr. Leonard commented that the layoffs at General Electric--which might not have been reported in time to be included in the red book--were caused mainly by a fall in demands for electric ranges, which in turn was associated with the weakness in the housing market. In his opinion, the low level of residential construction activity reflected a lack of demand.

Mr. Hayes observed that the income tax surcharges proposed by the President applied only to calendar year 1975 while the investment tax credit would last indefinitely, providing some stimulus, on balance, to the economy. He asked whether the stimulus might not be felt when economic activity was already in recovery, perhaps contributing to the sort of excessively rapid rebound that Mr. Partee had referred to.

In reply, Mr. Partee observed that a small permanent loss of revenue would result from adoption of the income tax recommendations endorsed by the President for individuals in the lower income brackets. With respect to the increase in the investment tax credit--to 10 per cent from the present rates of 4 per cent for public utilities and 7 per cent for other industries--the stimulative effects would be offset in part by a change in the treatment of depreciation for tax purposes. At present, depreciation was taken on the full cost of the purchased equipment, but under the new proposals, it could be taken only on the net cost after deduction of the tax credit. Except for public utilities--and for companies that purchased mainly short-lived equipment, which would now receive the full investment tax credit--the net stimulative effect might not be very great. It was possible that on further consideration the depreciation provision of the proposal would be changed.

In reply to a question by Mr. Hayes, Mr. Partee commented that the combination of growth in M_1 at the assumed rate of 5-3/4 per cent over the projection period and growth in nominal GNP at the projected rates implied some decline in short-term interest rates in the near term but then a rise in the second half of next year. He would not expect long-term rates to decline much if at all; even during the next few quarters, strong demands for funds in the long-term markets, as in 1970, would tend to hold up such rates.

Mr. Hayes observed that, while he was somewhat less optimistic about the outlook than he had been 5 weeks earlier, he still was somewhat more optimistic than the Board's staff, in large part because of the expected strength in business capital investment. Concerning Mr. Morris' question about the degree of slack being generated in the economy, he felt that much, perhaps most, of the developing slack was generated, not by monetary policy, but by the excesses of the past few years. A notable example was housing: while credit policy was a major deterrent to residential construction activity, of equal importance in contributing to the slack was the extraordinary increase in the price of housing and the over-building in many areas as a consequence of 3 or 4 years of high rates of construction activity. In the automobile industry, the prospective slack resulted from the large increases in prices on the new models and from the energy situation.

Chairman Burns commented that the major weakness in demand was in the consumer markets, including the market for housing, and that the weakness was directly attributable to the erosion in workers' real income caused by inflation. In his view, the recessionary tendencies now at work in the economy resulted mainly from the forces that had been released by the inflationary boom.

Mr. Mitchell said he agreed that the inflation-induced decline in real income was an important factor in the weakness in consumer demand, but it was also true that consumers were finding it impossible to finance turn-overs of houses because of the stance of monetary policy. Presumably, monetary policy had been tight because there had been a need to restrain expansion in activity.

The Chairman said he agreed that high mortgage interest rates and reduced availability of mortgage credit had had a major impact on residential construction. However, he would emphasize that sharply rising costs of land and construction, over-building in 1971, 1972, and part of 1973, and erosion in real purchasing power of consumers had been important in bringing on the decline in home-building activity.

Mr. MacLaury commented that in his view the main question was whether additional slack in the economy would be counter-productive. The issue, therefore, was whether the Committee should attempt to lessen the slack in prospect.

Mr. Kimbrel asked whether the CPI might not be overstating the actual rise in prices in view of more widespread discounting from list prices, special sales, and consumers' efforts to seek out bargains.

In response Mr. Partee noted that the CPI was based, not on list prices, but on actual prices collected by shopping in the market. However, special sales would be reflected in the index only if they occurred during the few days of the month in which price data were collected. With respect to automobiles, it might be difficult to determine dealers' transactions prices without actually making purchases.

Mr. Wallich remarked that he was puzzled by the implication of the projection that increased slack in the economy did not moderate the rise in prices, even though he recognized that exogenous forces, like poor crops, exerted upward pressures. One reason for the unusual price behavior might be the employment situation. An unemployment rate of 7 per cent, as projected to be reached in the second quarter of next year, was 3 percentage points above the rate that used to be associated with full employment. However, if one took the unpopular position that a 5 per cent rate now was a more appropriate full employment base, then the unemployment rate exceeded it by only 0.8 of a percentage point in September and would exceed it in the second quarter of next year by 2 percentage points. Moreover, the unemployment rate for married men--which was the most important group from the point of view of wage determination--had increased relatively little, to 2.8 per cent in September. The rate for married men excluding those unemployed for less than 5 weeks was only 1.5 to 2 per cent, and that was a more realistic measure of the labor force slack existing at the present time.

Mr. Partee remarked that the present structure of the labor force was such that a moderate decline in business activity probably would have little effect on wage demands. In addition, the large rise in the cost of living that had occurred over the past 2 years provided both organized and unorganized labor with a strong argument for substantial increases in wages, and employers were likely to agree that their employees should be compensated for at least a major share of the increase in the cost of living.

Mr. Wallich then asked if, given the prevalence of escalator clauses in wage agreements, the slackening in the rate of inflation projected for the latter part of 1975 might not result in a slowing of the advance in wage rates which would, in turn, further reduce pressure on prices. Also, he asked whether, following the very poor performance in recent quarters, significant gains in productivity might lie ahead as adjustments were made to the energy situation and as shortages of materials became less important.

Mr. Partee replied that the projected slowing in the annual rate of increase in the GNP deflator to 7 per cent by the fourth quarter of 1975 was expected to moderate the rate of increase in wages as the year progressed. Concerning productivity, the projections did incorporate an increase in the period ahead, although at a quite modest pace. One could argue for a higher rate of increase, but it would represent a significant departure from historical experience.

Mr. Winn asked how changes in wealth affected the staff projections.

Mr. Partee remarked that in the Board's model the changes in wealth had their main impact on consumption, although they also had some effect on capital spending. One of the ways in which monetary policy affected consumption was through its impact on the value of financial assets.

Mr. Pierce observed that for the period ahead a rise in prices of common stocks had been assumed, which had a significant influence on the behavior of consumption.

Mr. Winn commented that, surprisingly, sales of furs, jewelry, and other luxury goods appeared to be quite strong.

Mr. Black remarked that sales of high-priced lines of furniture seemed to be holding up better than sales of the lower-priced lines.

Mr. Kimbrel said luxury-type automobiles were selling well in his District.

Mr. Partee observed that reports from retailers indicated that, in general, consumers were shifting their purchases down in terms of quality and price. However, he had no evidence concerning luxury goods.

Mr. Coldwell noted that, as had been said earlier, monetary restraint--as well as inflation--had had a dampening effect on demands, particularly for consumer goods and in the construction industry. Presumably, that had been an objective of policy. The curtailment in demands was swelling inventories and slowing economic activity, and the problem in the period ahead was to halt the decline in activity before it became too deep.

Mr. Coldwell then asked about the revision in the staff's expectations for net exports, which seemed to be a major feature of the change in the staff's projections since the last meeting.

Mr. Bryant replied that the reduction in the projection of net exports reflected an upward adjustment in projected imports, which was attributable chiefly to higher prices.

Mr. Coldwell noted that a footnote in the green book called attention to revisions from previous green books in the procedure for estimating the fixed-weighted price index, and he asked what effect the revision had had on the estimates.

Mr. Partee replied that the projection procedures had been revised to incorporate additional components of the over-all GNP deflator. This change had raised the price index for the third quarter of this year, and for subsequent quarters, by about 1 percentage point.

In response to a further question by Mr. Coldwell, Mr. Partee said there was as yet no basis to judge how Christmas business might develop this year, but he expected that sales would be weak. Judging by Eastman Kodak's sales to retailers, the retailers were optimistic about selling cameras. However, retailers of furniture, appliances, and television sets, judging both from recent factory orders and consumer sales, were rather gloomy.

Mr. Eastburn said he had been assuming that, with a decline in interest rates and improvement in the availability of money next year, financial strains would ease and, in particular, the financial condition of banks would improve. He asked Mr. Partee, in view of his earlier statement about the financial difficulties that lay ahead, whether he expected that banks as well as others would experience difficulties.

Mr. Partee replied that bank liquidity positions probably would be easing, on the average, and the banking system as a whole would be under less pressure. The possibility that concerned him was that some particular banks might be known to have a large volume of loans to customers who were experiencing severe financial difficulty or even facing bankruptcy; those banks could well experience liquidity problems as deposits were withdrawn and loans failed to be paid off on schedule.

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 September 10 through October 9, 1974, and a supplemental report covering the period October 10 and 11, 1974. 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:

> Over the period since the Committee last met the monetary aggregates have generally fallen below the ranges of tolerance set by the Committee. Consequently, the Desk became more accommodative in supplying reserves, and short-term interest rates declined sharply. Longer-term markets also showed improvement, although the size of the corporate calendar and continued fears of inflation inhibited rate declines in that sector. The recent sharp rebound in stock prices also tended to lift some of the gloom that has depressed the financial markets for so long.
>
> In pursuing the Committee's goal of promoting moderate growth of the aggregates, money market conditions were progressively eased as the aggregates fell short of desired levels. While the average Federal funds rate declined in each week of the period, progress was not always smooth, as banks tended to manage their reserve positions cautiously and there was considerable uncertainty about the provision of reserves from market factors.
>
> In order to provide some measure of continuity to the money market, open market operations were extensive and frequently involved shifts from reserve supply to reserve absorption within a statement

week. Outright operations included the net purchase of $590 million of Treasury bills, $176 million of Treasury coupon issues, and $207 million of agency issues in the market, as well as a small net sale of bills to foreign accounts and redemptions of maturing Treasury bills in the regular weekly auctions. Reflecting reserve variability over the period, the temporary injection or withdrawal of reserves was quite large. Repurchase agreements totaled about $7 billion and matched sale-purchase agreements came to about $14 billion, including about $4 billion made with foreign accounts.

Short-term interest rates, as noted earlier, declined markedly over the period, reflecting market expectations of a weak economy and reaction to the declining Federal funds rate. In last Friday's auction, an average rate of 7.72 per cent was established for the 3-month Treasury bills, down 138 basis points from the rate established in the auction just prior to the last Committee meeting. The Treasury bill rate remained extremely volatile, reflecting changes in foreign demand and in the supply of bills by the Treasury, as well as the supply of bills in dealer hands. Thus the rate fell from over 9 per cent at the time of the last meeting to about 6 per cent toward the end of September before rebounding to about 7-3/4 per cent in Friday's auction.

Other short rates, as the blue book[1/] indicates, also declined markedly, and there was a substantial lessening of fears of disintermediation.

There was absolutely no market reaction to the news that Franklin National Bank had been declared insolvent and taken over, with FDIC assistance, by the European-American bank. While that smooth--and long awaited--transition had no market impact, it did have a pronounced effect on our reserve statistics. The takeover by the FDIC of the New York Reserve Bank's loan to Franklin had the effect of increasing non-borrowed reserves by $1.7 billion, with a like decline in member bank borrowing and net borrowed reserves. There is no reason to believe that those technical adjustments have had any effect on the market.

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

As far as the Treasury is concerned, it will be announcing shortly its plans to raise over $4 billion in cash by early November. This will involve an addition to the bill supply (tax-anticipation bills) but could include an intermediate issue. One can only hope that if an intermediate issue is included in the Treasury's cash plans, it will not complicate the Treasury's November refunding--the terms of which will be announced on October 30.

There are two other developments that I should mention to the Committee. First, the shift of reserves to the oil-producing countries--a matter that has been of considerable concern to the Committee--coupled with a virtual saturation of the Euro-dollar market, has meant that more of the Desk's activity for foreign official account has been for customers who are extremely interest rate conscious. Thus we have been making repurchase agreements for some of our customers--since the rate is well above the Treasury bill rate--and there is increased interest in bankers' acceptances. There has also been interest in Federal funds sales by foreign official accounts. These developments should be closely watched by the Committee.

Secondly, there surfaced last Friday the possibility that a number of commercial banks may be in the process of reviewing their policies with respect to loans to Goverment security and acceptances dealers. With banks under considerable pressure to contain their lending activity and with expansion raising questions of capital adequacy, there is some risk that their traditional lending to dealers may be curtailed. While I am not suggesting that dealers should be in any sort of a preferred position, adequate financing is a prerequisite for a viable market on which we and the Treasury are so dependent. Again, this is a matter that will bear close watching.

In response to a question by Chairman Burns, Mr. Holmes said the foreign official accounts with which it was making matched sale-purchase agreements were mainly OPEC countries. By making repurchase agreements, those accounts were achieving a higher rate of return than they would if they were investing in Treasury bills. Traditionally, the System had invested funds of foreign official accounts in Treasury bills and, to a much smaller extent, in bankers' acceptances. Those new and unusual developments should be watched closely.

Mr. Axilrod commented that he and Mr. Bryant had initiated a study of the problem in order to determine the implications, if any, for open market operations.

Mr. Morris observed that in his opinion System operations since the last meeting of the Committee had resulted in pressures in financial markets that were greater than intended. Specifically, data for the statement week ending September 25 clearly suggested that the aggregates were growing at rates below the ranges specified for the September-October period, and yet in the following statement week--the week ending October 2--the Federal funds rate averaged 11.04 per cent even though the lower limit of the specified range for the funds rate at that time was 10-1/2 per cent. According to the blue book, the Desk moved cautiously in the early part of the inter-meeting period, in part to avoid encouraging an unduly rapid decline in market rates. In his view, operations should not be influenced to that extent by a concern about unduly rapid declines in market interest rates. More generally, he believed there was a systematic propensity to avoid moving the funds rate--in either direction--to the extent necessary to control the aggregates. In the recent period, consequently, the Committee had lost ground in pursuit of its objectives for the aggregates.

Chairman Burns commented that on October 4 the Committee had concurred in his recommendation to reduce the lower limit of the funds rate range to 10-1/4 per cent, and in the last few days the rate had been 10 to 10-1/8 per cent. Early in the inter-meeting period, he had felt that the funds rate might appropriately have been somewhat lower, and one could argue--as Mr. Morris had--that the decline in the funds rate in the early part of the period should have been greater than it was. But there could be differences in judgment in the conduct of operations. By the end of the inter-meeting period the funds rate was roughly at the lower limit of its specified range, and for that reason, he did not believe that ground had been lost. Since the September meeting, interest rates on Treasury bills, commercial paper, and negotiable CD's all had declined by substantial amounts.

Mr. Eastburn remarked that in his judgment the basic issue was a reluctance on the part of Committee members to allow movements in the Federal funds rate of the sort necessary for achievement of the goals for the monetary aggregates.

Mr. Coldwell, noting that the weekly average funds rate had declined by more than 100 basis points since the last meeting, said he would compliment the Account Management for the smooth fashion in which the rate had declined. At the last meeting, several members of the Committee had emphasized the importance of conducting operations so as to avoid leading the market to expect a rapid shift in policy, and that had been accomplished to a considerable extent.

Mr. Sheehan said he agreed with Mr. Morris. Two or three times during the past year, he felt that the Desk had not acted briskly enough because of its excessive sensitivity to market conditions. Concerning operations in the period since the last meeting, he had been worried that the Desk had appeared to be unwilling to force the Federal funds rate down because of its concern that the market might over-react and push other market rates down too rapidly.

Mr. Black observed that the real problem, in his opinion, was that the market was not yet ready to accept large fluctuations in interest rates. Such acceptance would need to develop before the System could stabilize rates of growth in the monetary aggregates. He hoped that at some time in the future the market could be educated to accept greater fluctuations in interest rates. Concerning the Desk's conduct of operations in the recent period, he agreed with Mr. Coldwell.

Chairman Burns commented that the present would not be a good time to undertake any experiments in educating the market, because they might lead to undesirably sharp fluctuations in interest rates.

Mr. Kimbrel, noting that he was the Committee member who had participated in the morning call during the recent period, remarked that he had concurred completely in the operations of the Desk. In his opinion, the Manager was to be commended for conducting operations smoothly and efficiently. In view of the sensitive nature of the markets and the situation of the Franklin National Bank--which was in the process of adjustment--he would have been very reluctant to have eased reserve and money market conditions more rapidly. In retrospect, he would not have done anything differently.

Mr. Wallich commented that he, like other members, believed that the Committee had intended to achieve its goals in the inter-meeting period without signaling a shift in policy, and that objective had been accomplished. Early in the period he had been a little impatient for more of a decline in the funds rate than actually had occurred. However, the rate eventually was reduced, and it was uncertain how close the System had come to signaling a policy shift. The stock market had rallied strongly, for some reason, and short-term market interest rates in general had declined significantly. Concerning the broader issue of the width of the range of tolerance that the Committee established for the funds rate, he would say that the range was too narrow. The System ought to educate the market about its willingness to tolerate larger fluctuations in rates, although it ought not to do so at this time. When that was understood in the market, arbitrage would tend to limit the fluctuations in rates.

Mr. Mayo remarked that on several past occasions the Desk, in his opinion, had been slow in responding to the developing situation, but in the period since the last meeting the Desk had done a splendid job of carrying out the Committee's instructions. Judgments concerning day-to-day operations could differ, and it would be a mistake for the Committee to become involved in those very short-run operating decisions. Although he believed that the money supply had not increased sufficiently over recent months, he was not overly concerned because of the probabilities that the rate of growth would pick up over the next few months, thereby compensating for the recent shortfall.

Mr. Clay observed that the Committee's objective in the recent period--as he interpreted the discussion at the last meeting--was to attempt to preserve its posture with regard to slowing the rate of inflation and moderating inflationary expectations, while at the same time easing policy to a degree in order to provide some stimulus to economic activity 6 months or so in the future. It was important, therefore, that the easing be accomplished as quietly as possible, and in his opinion, the Desk had done a magnificent job. With respect to the sluggish rates of growth in the monetary aggregates, several influences had been at work. Economic activity appeared to have weakened more than had been projected; the demand for money was responding, with the usual lag, to the earlier increases in short-term interest rates; and because of the comparatively high prime rate at major banks, some borrowers were turning to other sources of funds. Banks were likely to remain cautious in easing lending terms until they had been able to improve their liquidity postures and reduce their reliance on borrowed funds. Given those influences, efforts to achieve faster rates of growth in the aggregates probably would have required more vigorous efforts to ease bank reserve and money market conditions than many members of the Committee would have been willing to accept.

Mr. Holmes commented that in the recent period the Desk had paid a great deal of attention to market expectations because of the Committee's desire to ease reserve and money market conditions somewhat without giving the market a strong signal of a policy shift. It was significant that during the first 3 weeks after the September meeting, when the funds rate was rather sticky, other short-term rates declined appreciably. The market rate on 3-month Treasury bills, for example, declined by about 3 percentage points. As bill rates moved up in early October, there was more leeway to allow the funds rate to decline without generating undesired expectations. At times during the period, nevertheless, he felt that the market was close to developing such expectations.

Mr. Mitchell observed that, in view of the growth in OPEC funds, he was particularly concerned about expanding foreign participation in U.S. debt markets. He asked whether System policy could be thwarted by the influence of that participation on either the rate of growth in M_1 or the behavior of the funds rate.

Mr. Holmes replied that foreign participation in U.S. markets--although it had become exceptionally large and had caused some day-to-day problems--had not interfered with the implementation of monetary policy. As he understood it, the shifts in OPEC funds had no impact on the rate of growth in M_1. However, inflows of funds were large, and managing the shifts into the United States without disrupting the market would be an increasing, although not an impossible, challenge. Treasury special certificates might have to be issued, as in past periods of large flows of funds. That would depend in part on whether oil-consuming countries lost reserves as rapidly as oil-producing countries gained them, so that the shifts in market instruments from gainers to losers of reserves could be orderly.

Mr. Axilrod remarked that the staff was preparing a paper dealing with the question raised by Mr. Mitchell, and some rather technical issues were involved. For example, if a country gained reserves in a manner that increased its balance at the New York Bank, bank reserves would be absorbed unless the Desk invested the funds promptly. If the period was one in which the Desk wanted to provide rather than to absorb reserves, it would be essential to invest the foreign country's funds promptly. Doing so, however, might so reduce the collateral available in the market that the Desk would encounter difficulties in achieving its objective of providing still more bank reserves. Thus, the difficult question arose as to whether shifts in dollar reserves among foreign countries should be managed wholly through the commercial banking system in order to eliminate their potential effects on bank reserves.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 10 through October 14, 1974, were approved, ratified, and confirmed.

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

The alternatives[1/] before you once again imply a further reduction of interest rates if the Committee wishes to maintain the 5-3/4 per cent longer-run growth rate for M_1 adopted at the last meeting. As the blue book notes, this is in part because M_1 in September and early October has been weaker than earlier expected. It is also because, looking ahead, GNP growth is projected to be weaker, particularly by the first quarter.

In the process of moving back toward the Committee's longer-run target, and recognizing the erratic nature of M_1 behavior, there will probably be some months of substantial M_1 growth to offset the recent very low growth rates. The forecasting art is certainly not sufficiently well developed so that we can tell precisely when such months will occur, or if indeed they will. But all of the alternatives presented assume a considerable rebound in money demand in November and December. If there were no such rebound in demand, following 4 months of low M_1 growth from June to October, it would appear to cast further doubt on the fundamental strength of the economy and of transaction demands for money.

History may be of some help in gauging the likelihood of a surge in M_1 growth toward year-end. In 1972 and 1973, there were very large increases in M_1 growth in the last 2 months of the year, averaging 10-11 per cent at an annual rate, but the expansion in nominal GNP in the fourth quarter of those years was about 4 to 5 percentage points stronger than expected this year. In 1970 and 1971, there was very little M_1 expansion in the last 2 months of the year. This appears to suggest that the odds of a surge in M_1 growth are not so great this year as in the past one, although it does not argue against some rebound, given the projected fourth-quarter GNP growth. If there is no strong rebound in M_1 demand, providing the reserves to accommodate substantial growth will be accompanied by greater declines of interest rates than now expected.

The alternative B specifications indicate that the Federal funds rate might decline to as low as 8-3/4 per cent between now and mid-November, although a more modest

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

decline to 9-3/4 per cent is shown as the center of the range. A substantial decline in the funds rate over the next few weeks is not likely to be interpreted by the market as pro-inflationary. It would be accompanied by a fairly significant downward adjustment in private short-term market rates and also by some decline in longer-term market rates. It would work to take pressure off key institutional rates; it would hasten declines in the prime loan rate, and would fairly soon be reflected in some easing in primary mortgage market rates. Thus, it would tend to support the weak housing sector of the economy and would also moderate pressure on business, financial firms, and investors who rely on bank loans to finance inventories of commodities and holdings of securities.

The Treasury will be raising a substantial amount of new cash in the period immediately ahead and will announce terms of the mid-November refunding on October 30, as Mr. Holmes has mentioned. Thus, the Treasury will be pretty much continually in the market between now and the next meeting. This suggests a cautious approach to any money market tightening, as might be required if the Committee opts for alternative C. On the other hand, I do not believe it necessarily requires unusual caution on the easing side. Because of the continuous flow of financings--both for new cash and refunding--some of the benefit of any easing will inevitably accrue to investors and some to the Treasury. However, if any action were to be taken that significantly altered the trend in policy, it might be more desirable to have it accomplished a few days before the October 30 announcement rather than after. As a minor point, that date might be moved closer to the early November auction date for the refunding, if the Treasury were to utilize a yield auction rather than to stipulate a coupon rate in advance.

Mr. Bucher asked whether there were any early indications of the nature of the next adjustment of the money supply series to the quarterly benchmark, and whether, because they were now made quarterly rather than annually, the adjustments were likely to be smaller than they had been in the recent past.

Mr. Axilrod replied that as yet he had no indications of the nature of the adjustment to the June benchmark, but data would be available in the near future. He hoped that the use of quarterly benchmarks would reduce the size of the adjustments.

Mr. MacLaury, noting Mr. Axilrod's statement to the effect that all three of the alternatives presented assumed a considerable rebound in money demand in November and December, asked whether there really was much basis for expecting a substantial pick up in monetary growth. Mr. Axilrod's reference to experience in the 1970-71 and 1972-73 periods seemed to suggest that greater declines in the funds rate would be necessary if the money supply were to grow at the rates indicated in the blue book alternatives.

Mr. Axilrod replied that on an assumption of prevailing money market conditions, essentially as under alternative C, various models and judgmental projections suggested that M_1

would grow in the fourth quarter at an annual rate of 6 per cent. For that rate to be achieved, an early and substantial pick up in monetary growth would be required. In his statement, he had intended to suggest that, given the uncertainty concerning forecasts of GNP, there was some reasonable probability that such a pick up would not occur. If a strong rebound in the demand for money did not occur, achievement of the monetary growth rates under, say, alternative B would require sharper decreases in interest rates than those now associated with that alternative.

Mr. Partee added that on a longer-run basis the staff's projection of monetary growth was consistent with its projection of nominal GNP. It was possible, however, that GNP would grow at a slower rate than projected or that, in the short run, the longer-term relationship between monetary growth and GNP growth would not prevail. When business activity was weakening, there might be a greater tendency for monetary growth to fall short of the rate indicated by the longer-term relationship. If, for example, Christmas sales were poor, monetary growth might remain sluggish.

Chairman Burns then called for the Committee's discussion of monetary policy and the directive. He might begin the discussion by expressing some of his own views. It was clear to him--as he believed it was to most, if not all, members of the Committee--that business activity was in a recession, although an unusual one. He knew of no earlier instance when over-all business activity had been declining for a number of months and yet business capital investment had continued to expand. And if the advance indicators were reliable now, as they had been in the past, the volume of capital investment, at the worst, would flatten out. Under those circumstances, he would judge that the recession--even though likely to deepen and to cause some hardship--would not be as severe as suggested by some commentators. At the same time, inflation was continuing at a two-digit rate. It remained a serious worldwide problem that threatened not only the economic system but social and political institutions as well. If the rapid inflation were not brought under control, those institutions might be severely tested.

Continuing, the Chairman observed that the problem of inflation had been caused in large part by excessively expansive fiscal and monetary policies over a number of years.

Therefore, any easing of monetary policy at this time should be undertaken very cautiously; monetary policy should remain moderately restrictive. Continued pursuit of such a policy was likely to have a favorable influence on both the Administration and the Congress in their dealing with the problem of inflation. Although fiscal policy might not prove to be any tighter, other important issues were involved. In his recent speech on the economy, the President had emphasized policies affecting foods, fuels, antitrust and other regulatory activities, and labor-management relations. Maintenance of a basically restrictive monetary policy might have a beneficial effect on the vigor with which anti-inflationary policies were pursued in those areas.

At the same time, the Chairman said, a decision at this meeting to ease money market conditions somewhat further would be appropriate. Growth in the monetary aggregates had been sluggish in recent months; the home building industry was experiencing severe difficulties, in large part because of high interest rates and the limited availability of bank credit to builders; and security markets were not functioning as well as desired. It was important, however, that the Committee avoid easing policy too much.

Mr. Bucher remarked that his own views were expressed exactly by the remarks the Chairman had just made.

Mr. Hayes observed that the Committee might be confronted with a difficult dilemma. The longer monetary growth remained sluggish, the more appropriate it would be to take measures to encourage a resumption of more satisfactory growth even though little if any progress had been made in dampening inflation and inflationary expectations. The President's economic program, while pointing the way in many useful directions, offered little hope of real progress toward effective fiscal restraint or other significant measures to counter inflation. Monetary policy, therefore, remained exposed--as much as before, and perhaps more so because there was less reason to hope that it would be strongly supported by other policies. Policy had to remain basically restrictive, unless a real risk of a cumulative business downturn became evident or liquidity pressures became greater. International developments also had reflected some disappointment with the President's program and had demonstrated that the dollar, to a degree, was vulnerable to the easing in interest rates that had been occurring in this country.

Continuing, Mr. Hayes remarked that long-term credit demands remained surprisingly strong and were likely to continue to spill over into short-term markets. Bank loan demand had remained especially strong in the New York District, and it was not clear whether the lower growth of bank credit elsewhere in the country was due more to declining demand or to more stringent lending policies on the part of the banks. The Committee continued to be up against the old danger that modest slackening of monetary restraint might be over-interpreted by the market and might lead to an unwanted acceleration of inflationary expectations. The recovery in the stock market could be welcomed, because the extreme decline had been an adverse economic influence. But there was a risk that the Committee might be thought to be about to embark on a policy of aggressive ease, and that was something the members should try to avoid.

Concerning the specifications, Mr. Hayes said he was reconciled to a longer-term M_1 target of 5-3/4 per cent, as under alternative B, in view of the slowdown in monetary growth in the third quarter. The short-run ranges of tolerance for M_1 under alternative B also were acceptable, but he would like to see the Federal funds rate--which had dropped precipitously--maintained close to its current level. For the funds rate, he preferred a range of 10 to 11 per cent, which had the same mid-point as the wider range suggested under alternative B, but he could accept a range of 9-1/2 to 11 per cent.

Mr. Hayes commented that a reduction in reserve requirements might be a partial substitute for open market operations in the approaching period of seasonal reserve needs, but it should be made clear that any reduction was not to be construed as an overt signal of additional ease. Concerning the discount rate, some directors of the New York Bank recently had indicated a belief that the time was close for consideration of a reduction. However, he thought a reduction now would be premature. The decline in short-term interest rates that had occurred over the past few months had been useful in relieving liquidity pressures and disintermediation problems, and it might be desirable for the System to accommodate a further decline if the behavior of credit demands and that of the monetary aggregates seemed to warrant it. But that was quite different from giving an overt signal, as a reduction in the discount rate would do, especially when the gap between that rate and market rates remained wider than it normally had been in recent years. It was of crucial importance that the System not undermine the belief that it meant business about combatting inflation.

In response to a question by the Chairman, Mr. Hayes said he foresaw an unemployment rate of about 6.5 per cent in the middle of 1975.

Mr. Mitchell observed that he was concerned about the possibility of the recession becoming serious. While noting the Chairman's judgment that a serious recession would not develop if, at the worst, business capital investment flattened out, he believed that a decline in investment would be induced by the high level of long-term interest rates now prevailing. Moreover, the construction industry had been severely weakened. Because of the length of time required to change attitudes throughout the building industry and in the thrift institutions, any expansive policy decisions taken by the Committee today would not affect construction employment for a year to a year and a half. Consequently, it appeared critical to attempt to bring long-term interest rates down to levels that would improve the effectiveness of the longer-term markets for funds. He hoped that a marked change in monetary policy would not be required for the purpose and that other, selective, instruments could be used to stimulate a substantial flow of funds into the thrift institutions. To achieve that objective without the use of selective instruments would call for a somewhat easier monetary policy than implied by alternative B. In addition, it was essential to raise the rate of growth in M_1. While he was not particularly concerned about the rate of monetary growth, the public was. For the time being, however, he could accept alternative B, but with a Federal funds rate range of 9 to 11 per cent instead of 8-3/4 to 10-3/4 per cent.

Chairman Burns, responding to questions by Messrs. Mitchell and Sheehan, observed that--in the context of his earlier remarks--he would regard a recession as serious if the rate of unemployment clearly rose above the level of about 7 per cent that had been reached in the recession of 1957-58. One might or might not wish to make some allowance for the changes in the structure of the labor force that had occurred since then, which tended to raise the rate of unemployment, but he doubted that the allowance would be as much as 1 percentage point. With respect to Mr. Mitchell's remarks, he agreed in general, but he doubted that an easing of monetary policy could have a significant influence on long-term rates. To bring those rates down significantly, some evidence that inflation was being brought under control probably would be necessary.

Mr. Mitchell remarked that while it would be unreasonable to expect long-term rates to decline to the neighborhood of 6 per cent, it was also unreasonable to expect residential construction activity to recover with mortgage rates near 10 per cent.

Chairman Burns commented that the $3 billion of Government funds that recently had been released to GNMA to provide support to the market for conventional mortgages probably would be exhausted quickly, and the President was likely to authorize release of additional funds. Moreover, the Administration was considering programs to improve the flow of funds into the thrift institutions. Even without such programs, the worst might have been past; inflows into the savings and loan associations had picked up significantly in September--to a seasonally adjusted annual rate of 6.5 per cent--and the recent and prospective declines in market interest rates might sustain the improvement. Eventually, the improved inflows would provide stimulus to home building, although the S&L's were likely to strengthen their liquidity positions for a time before they became eager to make new mortgage commitments.

Mr. Morris said he believed that monetary policy had to be formulated on the assumption that the deeper the recession proved to be, the greater were the probabilities that Government policies adopted to combat it would produce too sharp a recovery. In order to restrain the contraction in business activity to the sort of mild recession that would be productive in reducing the rate of inflation over the longer run, the Committee had to be willing to tolerate enough of a reduction in the Federal funds rate to raise the rate of monetary growth.

Continuing, Mr. Morris remarked that he favored the rates of monetary growth under alternative B. If the longer-run M_1 target of 5-3/4 per cent were achieved, the course of economic activity would likely be better than that projected by the staff. But if expansion in M_1 over the months ahead fell short of the projected path--and growth over the second half of this year proved to be at an annual rate of only 1 or 2 per cent, rather than a little over 4 per cent--the System would encounter severe and deserved criticism. In his judgment, the alternative B targets for the monetary aggregates could not be achieved with the range of tolerance indicated for the funds rate. Accordingly, he would specify a lower limit of 8 per cent, rather than 8-3/4 per cent, and would instruct the Desk to give high priority to achieving the desired rates of growth in the aggregates.

Mr. Mayo commented that in his view the longer-run M_1 target of 5-3/4 per cent under alternative B was still appropriate. To a degree, achievement of that target would make up for the recent shortfall in monetary growth, and yet it was basically the kind of restrictive policy that the Chairman had described earlier. In his opinion, the importance of the shortfall had been over-emphasized in terms of the System's ability to achieve its longer-run objectives, but he recognized that the Committee had to pay more attention to short-term fluctuations in monetary growth than he would like, because of press interpretations of their significance. However, even if the rate of growth in M_1 fell somewhat short of the alternative B projections of 9 and 8.2 per cent for November and December, respectively, the recovery from the low rates of recent months would be publicly acceptable. Consequently, he subscribed to the specifications and the language of alternative B, although he would reduce the lower limit of the funds rate range in order to provide the Desk with additional leeway. The System should attempt to accommodate continuance of the downtrend in interest rates--not encouraging a rapid decline nor, what would be worse, preventing a decline altogether.

Mr. Coldwell remarked that the Committee had been pursuing a gradual approach to easing policy, attempting to maintain as much restraint as possible without aggravating recessionary tendencies, and such an approach involved the risk of deepening the recession as well as the risk of promoting too rapid a recovery. While he was uneasy about the economic outlook, he also would be uneasy about any System action that might be interpreted by the market as a shift away from restraint, and until it was clear that Federal expenditures would be held down, he would hold to a policy of restraint. In past economic downturns, policy often had been eased too early and too massively.

In continuance of the gradual approach, Mr. Coldwell said he favored alternative B, except that he would specify a range of 9 to 10-1/2 per cent rather than 8-3/4 to 10-3/4 per cent for the Federal funds rate. Believing that the System should not take any overt actions to ease at this time, he would not lower the discount rate and would reduce reserve requirements only if it were emphasized that the purpose of the reduction was to meet the seasonal need for reserves. With respect to the draft of the directive, he would modify the paragraph concerning the President's program by deleting the reference to the impact of fiscal restraint, because he thought there had not been any fiscal restraint, and he would delete the word "harsh" in describing the impact of monetary restraint. Thus, the first sentence would read "On October 8 the President announced a program to combat inflation and to mitigate the impact of monetary restraint on certain sectors of the economy."

Mr. Holland commented that he also had a proposal concerning that sentence of the draft directive. The President's program was intended to mitigate the impact of inflation as well as the effects of policy, and it would mitigate only the harshest impacts. Therefore, he would say ". . .the President announced a program to combat inflation and to mitigate the harshest impact on certain sectors of the economy."

Mr. Hayes remarked that he preferred not to characterize the impact of monetary policy as harsh.

Chairman Burns observed that the President's recommendation that total Federal budget outlays in fiscal 1975 be held to less than $300 billion represented fiscal restraint. He suggested that the sentence read "On October 8 the President recommended a program to combat inflation and to mitigate the impact of monetary and fiscal restraint on certain sectors of the economy." He asked the members to indicate whether that language would be acceptable.

A majority of the members indicated that the language proposed by the Chairman would be acceptable.

Mr. Sheehan commented that he agreed with much of what Messrs. Mitchell and Morris had said. With respect to business capital investment, he disagreed with the Chairman's view that it would continue to buoy the economy; business confidence was very weak, and some investment projects could be canceled merely by decisions of boards of directors. He would be satisfied with the specifications of alternative B, because he believed that in the event the aggregates appeared to be growing at rates below the specified ranges, the Chairman would recommend that the lower limit of the funds rate range be reduced, as he had done in the period since the September meeting. He felt that the System was particularly vulnerable because of the way in which members of the Congress perceived current monetary policy.

Mr. Leonard remarked that he could associate himself with the comments that the Chairman had made at the outset of today's discussion of policy. He believed that the third-quarter rate of increase in M_1--now indicated to be 3.6 per cent on the quarterly average basis--would be revised upward. With respect to the future, he could support alternative B; while it implied M_1 growth from the third to the fourth quarter at a rate that he believed was too low, the shortfall would be about made up by growth from the fourth quarter to the first quarter of next year at a rate that he regarded as too high.

Chairman Burns commented that M_1 growth on the quarterly average basis was 5.8 per cent in the first quarter of this year and 7.3 per cent in the second quarter. Even if the rate for the third quarter was not revised upward from 3.6 per cent, the average for the second and third quarters together would be close to 5.5 per cent. While he believed that the shortfall should be compensated for, its importance should not be exaggerated.

Mr. Kimbrel observed that some recent developments suggested that the economy was weaker than it had been thought to be, but as long as the Federal budget remained in deficit, there was little danger of a cumulative decline. While the weakness was onerous in terms of its effect on employment, it would improve the outlook for a return to price stability. Continuance of a policy of monetary restraint was necessary, and he hoped that the System would not give the impression that it had abandoned its role in fighting inflation even before the President's recommendations were acted on. Time was on the side of continued restraint in that banks were likely to be rebuilding their liquidity, but they were earnings-oriented and would be quick to expand their operations if they believed that the System had shifted to a policy of ease.

Mr. Kimbrel said he could accept the specifications of alternative B, except for the 8-3/4 per cent lower limit of the range for the funds rate. A drop in the rate below 9 per cent, coming after the decline that had already occurred, would be interpreted by the market as a rapid shift to a policy of ease. He would not like to see the rate fall below 9 per cent in the period until the next meeting of the Committee.

The Chairman then asked Mr. Partee for his policy recommendations.

Mr. Partee said he had nothing to add to his earlier remarks regarding the general economic and financial outlook. He would be prepared to accept the policy course set forth by alternative B, but would be very quick to depart from it if it appeared that in the October-November period the aggregates were growing at rates below their specified ranges.

Mr. Eastburn remarked that in attempting to step up monetary growth the Committee might stimulate a rate some months ahead that would be too rapid, and it would then be faced with the issue of whether to tighten money market conditions at an unfavorable time. He favored alternative B, with the funds rate range as indicated under that alternative, and like Mr. Partee, he would be quick to depart from it if it appeared that growth in the aggregates was not picking up. In order to allow for the acceptance of unexpected expansion in M_1, he would widen the 2-month range from 4-3/4 to 6-3/4 per cent, as indicated under alternative B, to 4-3/4 to 8 per cent.

Concerning the discount rate, Mr. Eastburn observed that it was early for a reduction. However, the Treasury would be in the market for a considerable period of time starting shortly and ending with its mid-November financing, and therefore, he would be inclined to recommend a one-quarter point reduction earlier than ordinarily would be called for to fine-tune the rate in the manner that he desired. He asked Mr. Holmes whether the market had already discounted a reduction or would be surprised by one.

Mr. Holmes replied that he thought there would be only a mild reaction to a reduction in the discount rate at this time, that the cut would be taken as confirmation of the easing that had already occurred. The reaction would be stronger if the cut came when the funds rate was declining rapidly or if it was accompanied by a reduction in reserve requirements.

Mr. Wallich commented that actions taken to raise the rate of monetary growth after a period of shortfalls should not be viewed as an easing of policy. The Committee's task at this time was to raise M_1 growth from the low rate of recent months, while taking account of the danger, mentioned by Mr. Eastburn, that an upsurge in growth would put the Committee in the uncomfortable situation of having to tighten money market conditions while economic activity was in recession. Raising the rate of M_1 growth was particularly important, because prospective rates of growth in M_2 and in RPD's exceeded that in M_1 by less than the usual amounts. He remained concerned about the possibility of giving false signals to the market. However, that danger might have lessened; as money market conditions had eased in recent months, nothing dramatic had occurred in the markets, suggesting that participants understood current policy. Accordingly, he was less concerned about the amount of decline in the funds rate constraint. He favored alternative B, and would be willing to shade the lower limit of the funds rate range down from 8-3/4 per cent to 8-1/2 or 8-1/4 per cent.

Mr. Holland observed that he agreed with the Chairman's comments concerning the economic situation and monetary policy. He favored alternative B, and he believed that the Manager ought not to wait until new data for the aggregates became available but, within the framework of that alternative, should proceed actively to reduce the funds rate; he should aim to get the rate down into the range of 9-1/2 to 9-3/4 per cent, so long as the aggregates did not appear to be growing at rates at or above the upper limits of their specified ranges.

Chairman Burns expressed the view that the framework of alternative B implied the course of action suggested by Mr. Holland. He asked Mr. Holmes whether that was his understanding as well.

Mr. Holmes replied that it was.

Mr. MacLaury remarked that the prospective slack in the economy was counter-productive in that the decline in activity would be excessive in relation to its effect in reducing the rate of increase in prices and would lead to a counteraction. Like some other speakers, he believed that the current stance of monetary policy should not be characterized entirely in terms of the behavior of interest rates. The Committee had been focusing on the behavior of the aggregates, and in fact, he understood the Chairman's public statements about avoiding a credit crunch to mean that growth in the aggregates would be maintained. For that reason alone, the Committee had a strong interest in raising the rate of monetary growth.

Accordingly, Mr. MacLaury said, he favored the specifications of alternative B. Like Mr. Morris, however, he would reduce the lower limit of the funds rate to 8 per cent--or, at least, to 8-1/4 per cent--and would expect that the funds rate target would be moved down. According to the blue book, even alternative A would result in fourth-quarter growth in M_1, on the quarterly average basis, of only about 4.5 per cent; to him, that did not appear to be excessive monetary ease.

Mr. Black observed that the objectives of controlling inflation and cushioning the decline in economic activity might appear to be conflicting, but he did not believe that they were. For a long time, it had been the Committee's objective to foster moderate monetary growth, and that objective continued to be appropriate. To achieve it--to raise the rate of growth in the aggregates--required some further easing in interest rates. Accordingly, he favored alternative B.

Mr. Winn remarked that the meaning of M_1, like that of the unemployment rate, might have undergone some change. To some extent, corporations now held CD's in place of demand deposits, and the slowdown of M_1 growth in recent months might need to be interpreted differently than in the past. He found the specifications of alternative B acceptable.

Mr. Williams said he favored alternative B.

Mr. Clay observed that he agreed with the Chairman's remarks opening the policy discussion today, except for the statement that a decision to ease money market conditions somewhat further would be appropriate. He would be very cautious in reacting to the recent shortfalls in M_1 growth, believing that they were not entirely due to the weakness in economic activity but at least in part were a lagged response to the high levels of short-term interest rates prevailing in the spring. The rate of monetary growth was likely to pick up, and Committee members should be concerned about the possibility of provoking a rate of growth that was too rapid, thereby earning the criticism that policy was conducted on a stop-and-go basis. He would like to get the full benefits of the policy course that the Committee had been following, even though he recognized that that course caused problems for some individuals and businesses. The decline in the Federal funds rate that had already occurred--from an average of 12.92 per cent in July to an average of about 10.5 per cent in the week ending October 9--was very dramatic.

Accordingly, Mr. Clay said, he favored the language of alternative C and, with some modifications, the specifications of that alternative. He would raise the M_1 short-run range of tolerance slightly--to 4-1/2 to 6-1/2 per cent--and would lower the funds rate range slightly, to 9 to 11 per cent. While he favored the longer-run targets of alternative C, he could accept slightly higher rates--namely, 5-1/2, 6-1/2, and 6-1/2 per cent for M_1, M_2, and the credit proxy, respectively. In his view, the tendency always was to react too soon to weakness in economic activity and not soon enough to inflationary developments.

Mr. Bucher remarked that he favored the specifications of alternative B. He would be prepared to reduce the lower limit of the funds rate range in the event that growth in the aggregates appeared to be at rates below the short-run ranges of tolerance.

Chairman Burns said he believed, on the basis of the discussion, that a majority of the members favored alternative B, and in his own view, the specifications of that alternative were close to the mark. He would raise the upper limits of the short-run ranges of tolerance for the aggregates by 1/2 of a percentage point; thus, the ranges would be 4-3/4 to 7-1/4 per cent, 5-3/4 to 8-1/4 per cent, and 5-1/2 to 8 per cent for M_1, M_2, and RPD's, respectively. For the Federal funds rate, he would narrow the range while retaining the mid-point indicated under alternative B;

he would recommend a range of 9 to 10-1/2 per cent, rather than the alternative B range of 8-3/4 to 10-3/4 per cent. During the course of the period before the next meeting, he would follow the behavior of the aggregates very closely, and in the event that growth continued to fall short of the specified ranges, he would make appropriate recommendations to the Committee.

The Chairman asked the members to indicate informally whether they could accept the short-run ranges for the aggregates that he had suggested.

A majority of the members indicated acceptance of those ranges.

The Chairman then asked the members to indicate whether they could accept the range that he had recommended for the Federal funds rate.

A majority of the members indicated acceptance of that range.

Chairman Burns proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs, as altered earlier, and alternative B 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 August 1974 to March 1975--would be 5-3/4, 6-3/4, and 6-3/4 per cent for M_1, M_2, and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the October-November period would be 5-1/2 to 8 per cent for RPD's, 4-3/4 to 7-1/4 per cent for M_1, and 5-3/4 to 8-1/4 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 9 to 10-1/2 per cent.

Mr. Clay indicated that he planned to dissent from the proposed directive.

With Mr. Clay 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 declined somewhat further in the third quarter and that price and wage increases continued large. In September industrial production increased somewhat, reflecting settlement of work stoppages that had reduced output in August. An upsurge in the labor force, following several months of relatively slow growth, raised the unemployment rate from 5.4 to 5.8 per cent. The rise in wholesale prices of industrial commodities moderated, although it remained substantial, and prices of farm products and foods declined after having increased sharply in July and August.

On October 8 the President recommended a program to combat inflation and to mitigate the impact of monetary and fiscal restraint on certain sectors of the economy. The tax and expenditure proposals included in the program would, on balance, have approximately a neutral effect on the size of the Federal deficit.

In recent weeks the dollar has declined against leading foreign currencies. The U.S. foreign trade deficit increased substantially in August, as imports of petroleum and industrial materials rose while exports held steady.

The narrowly defined money stock rose slightly in September and grew at an annual rate of about 2 per cent over the third quarter, compared with a rate of 6 per cent in the first half of the year. The money supply measure more broadly defined to include bank time and savings deposits other than money market CD's--as well as the measure that includes deposits at other thrift institutions--also rose only slightly in September. Over-all business credit demands slackened last month, and outstanding business loans at banks leveled off. Since early September interest rates on short-term market instruments have fallen considerably, while yields on Treasury and State and local government bonds have declined modestly. Yields on corporate bonds have risen somewhat further, on balance, reflecting the large volume of offerings in prospect.

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, supporting a resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

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

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

The Chairman asked Mr. Broida to comment on the matter of the Committee's 1975 meeting schedule.

Mr. Broida noted that the tentative meeting schedule set forth in a memorandum from the Secretariat dated October 8, 1974[1/] involved meetings on the third Tuesday of every month except February, when the meeting would be on the third Wednesday, because of a holiday on the third Tuesday.

It was agreed that the tentative schedule proposed in the memorandum of October 8 was satisfactory.

It was agreed that the next meeting of the Committee would be held on November 19, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida
Secretary

1/ A copy of the document referred to has been placed in the Committee's files.

ATTACHMENT A

October 11, 1974

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 15, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services declined somewhat further in the third quarter and that price and wage increases continued large. In September industrial production increased somewhat, reflecting settlement of work stoppages that had reduced output in August. An upsurge in the labor force, following several months of relatively slow growth, raised the unemployment rate from 5.4 to 5.8 per cent. The rise in wholesale prices of industrial commodities moderated, although it remained substantial, and prices of farm products and foods declined after having increased sharply in July and August.

On October 8 the President announced a program to combat inflation and to mitigate the harsh impact of monetary and fiscal restraint on certain sectors of the economy. The tax and expenditure proposals included in the program would, on balance, have approximately a neutral effect on the size of the Federal deficit.

In recent weeks the dollar has declined against leading foreign currencies. The U.S. foreign trade deficit increased substantially in August, as imports of petroleum and industrial materials rose while exports held steady.

The narrowly defined money stock rose slightly in September and grew at an annual rate of about 2 per cent over the third quarter, compared with a rate of 6 per cent in the first half of the year. The money supply measure more broadly defined to include bank time and savings deposits other than money market CD's--as well as the measure that includes deposits at other thrift institutions--also rose only slightly in September. Over-all business credit demands slackened last month, and outstanding business loans at banks leveled off. Since early September interest rates on short-term market instruments have fallen considerably, while yields on Treasury and State and local government bonds have declined modestly. Yields on corporate bonds have risen somewhat further, on balance, reflecting the large volume of offerings in prospect.

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, supporting a 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 the forthcoming Treasury financing and of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with substantial growth in monetary aggregates over the months ahead.

Alternative B

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

Alternative C

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

ATTACHMENT B

October 15, 1974

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 10/15/74)
A. Longer-run targets (SAAR): (September plus fourth and first quarters, combined)	M_1	5-3/4%
	M_2	6-3/4%
	Proxy	6-3/4%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (October-November average):		5-1/2 to 8%
2. Ranges of tolerance for monetary aggregates (October-November average):	M_1	4-3/4 to 7-1/4%
	M_2	5-3/4 to 8-1/4%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		9 to 10-1/2%
4. Federal funds rate to be moved in an orderly way within range of toleration.		
5. Other considerations: account to be taken of Treasury financing and 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.