MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, October 20, 1970, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Francis
Mr. Hickman
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Sherrill
Mr. Swan
Mr. Morris, Alternate for Mr. Heflin

Messrs. Galusha, Kimbrel, and Mayo, Alternate Members of the Federal Open Market Committee

Messrs. Eastburn, Clay, and Coldwell, Presidents of the Federal Reserve Banks of Philadelphia, Kansas City, and Dallas, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Mr. Kenyon, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Craven, Garvy, Gramley, Hersey, Hocter, Parthemos, Reynolds, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Messrs. Bernard and Leonard, Assistant Secretaries, Office of the Secretary, Board of Governors
Mr. Cardon, Assistant to the Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors

Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Ormsby, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Miss Orr, Secretary, Office of the Secretary, Board of Governors

Messrs. Black and Fossum, First Vice Presidents, Federal Reserve Banks of Richmond and Atlanta, respectively
Messrs. Eisenmenger, Taylor, and Tow, Senior Vice Presidents, Federal Reserve Banks of Boston, Atlanta, and Kansas City, respectively
Messrs. Scheld, Andersen, and Green, Vice Presidents, Federal Reserve Banks of Chicago, St. Louis, and Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on September 15, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on September 15, 1970, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open

Market Account and Treasury operations in foreign currencies for the period September 15 through October 14, 1970, and a supplemental report covering the period October 15 through 19, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that trading in the foreign exchange markets had remained orderly, mainly reflecting, unfortunately, the harmonization of inflation in the major industrial countries. The United Kingdom was a good illustration of such offsetting of domestic by foreign inflation. During the past year, wage rates in the United Kingdom had risen by about 11 per cent, and the British Government apparently was prepared to accept new wage settlements ranging up to 14 per cent. A few years back, such a performance would have had serious repercussions on sterling, but the British trade figures for September were surprisingly favorable in light of the wage-cost situation. The protection thus afforded the British by inflation in Germany and other competing markets had apparently been accompanied by a significant improvement in the terms of trade of the United Kingdom, probably at the expense of the countries producing raw materials. In the third quarter, British export prices rose by 8 per cent while import prices were virtually unchanged.

How long that artificial situation could last was questionable, Mr. Coombs continued. Governor O'Brien of the Bank of England in a major speech last week had challenged the Conservative Government's assumption that it could break the present inflationary spiral without recourse to an incomes policy. Meanwhile, however, reactions to the release of the September trade figures had enabled the Bank of England to take in $150 million last week and to pay off $50 million yesterday (October 19) of their $400 million swap debt to the System.

Mr. Coombs thought the most important influence on sterling in the period before the year end would be the relationship between credit conditions in the United Kingdom and those in the Euro-dollar market. If market interest rates remained reasonably stable in the United Kingdom, the British might benefit importantly from further easing in the Euro-dollar market. Such flows of dollars to the United Kingdom would also be advantageous to the United States by providing a safe outlet for potentially sizable repayments of Euro-dollar borrowings by American banks.

Mr. Coombs observed that the recovery of the Italian lira had moved to more solid ground as technical short covering had now been reinforced by improving trends in both exports and imports. Much of the difficulty the Italians had encountered earlier in the year arose from industrial strikes, which had tended to frustrate exports while encouraging imports. Now that production was getting back into full gear it appeared that the Italian competitive position, which had been unusually strong in recent years, had not been seriously damaged by the wage inflation experienced during the past year. Premier Colombo had personally intervened in the wage bargaining process and much would now depend on his success in persuading the trade unions to limit their demands to what the Italian economy could support. Meanwhile, the Bank of Italy's reserves were also benefiting from relatively tight credit conditions in Italy in relation to those in the Euro-dollar market. That development was helping to provide a safe outlet for funds returned to the Euro-dollar market by U.S. banks. In view of the heavy borrowing by Italian official agencies in the Euro-dollar market earlier in the year, he thought the Bank of Italy could easily absorb as much as $1 billion in reserve gains before creating operational problems for the Federal Reserve or the U.S. Treasury.

Mr. Coombs added that much the same was true of France, where continuing dollar accruals in moderate amount would probably be set aside against debt obligations of $1 billion to the International Monetary Fund. This morning the Bank of France had announced a reduction in its discount rate from 7-1/2 to 7 per cent.

Mr. Coombs noted that Germany had been the major recipient of dollars being fed into the Euro-dollar market through the U.S. payments deficit and the runoff of Euro-dollar borrowings by U.S. banks. Since last May the reserves of the German Federal Bank had risen by $3.7 billion and had now reached a level almost equal to their peak level before revaluation. However, Germany also continued to provide a reasonably safe outlet for dollar accruals. He thought the German Federal Bank was unlikely to ask the United States for swap line drawings, Special Drawing Rights, or gold in exchange for dollars originally borrowed on the initiative of German residents, largely German industrial firms.

Thus, Mr. Coombs said, the financing problem so far narrowed down to the Netherlands, Belgium, and Switzerland. The accumulated System swap debt to those countries now totaled $755 million. There might well be a further growth of the System's swap debt to the Dutch and Belgian central banks over the next few months. But even if current flows of short-term funds to the Netherlands and Belgium were not reversed after the turn of the year, the swap debt could be liquidated without undue strain by U.S. Treasury recourse to credits from the Fund or by the sale of SDR's.

The situation with regard to the Swiss franc was different, Mr. Coombs observed. The Federal Reserve had already drawn $300 million on its Swiss franc swap lines and might have to make further drawings before year end. Settlement of that swap debt would probably pose a problem for the Swiss as well as for the Federal Reserve, since Switzerland was not a member of the International Monetary Fund. Some gold might therefore be required to settle the Swiss franc debt, but he would not expect it to be in large amount, as the Swiss might be willing to add substantially to their uncovered dollar holdings.

In general, Mr. Coombs continued, the runoff of U.S. bank borrowings in the Euro-dollar market had been financed so far without undue difficulty, and he thought there was still some scope for a further reduction--up to perhaps $2 billion or so--before troublesome financing problems were encountered. He could see some advantage in having the reduction occur before year end in view of the large return flow of dollars expected later in the year in conjunction with seasonal window-dressing transactions. Actual developments would be importantly influenced, of course, by conditions in European domestic credit markets in relation to those in the Euro-dollar market. The extent of the U.S. financing problem would also depend in large measure on whether certain debtor countries--such as the United Kingdom, France, and Italy--retained a competitive advantage in international financial markets. Beyond the year end the outlook became increasingly ominous, since the more or less automatic financing facilities so far available to the United States might well be largely exhausted by spring if the U.S. balance of payments deficit and repayments of Euro-dollar borrowings by U.S. banks continued large.

Mr. Coombs remarked that the Fund and Bank meetings in Copenhagen last month had had a temporarily stabilizing influence on the exchange markets. The markets had never taken very seriously the various proposals of recent years calling for greater exchange rate flexibility; and the IMF report on the subject, together with various official statements made in Copenhagen, had strengthened the market's impression that no significant changes were likely to be made in current arrangements. In fact, the only positive initiative to come out of the rate flexibility discussions so far had been a Common Market agreement to reduce, rather than to enlarge, the present flexibility of their currency rates.

As the Committee knew, Mr. Coombs said, the present band between the floor and ceiling quotations of the European currencies against the dollar was 1.5 per cent. The Common Market countries expected to take joint action early next year to narrow that band by gradual steps from 1.5 to, perhaps, 1 per cent. The Common Market central banks would continue to use the dollar for exchange market intervention as they did now. The new 1 per cent band would apply to day-to-day transactions, but that band could be moved up or down within the outer limits of the current 1.5 per cent band by joint agreement of the Common Market countries in accordance with their over-all balance of payments position. For example, if the Common Market countries were in a strong surplus position, they could move the new 1 per cent band up to the ceiling, in which case the upper limit would be 3/4 per cent above par and the lower limit 1/4 per cent below par. If they were in deficit they could move the 1 per cent band down to the floor, with limits at 3/4 per cent below par and 1/4 per cent above par. He suspected that in actual practice the 1 per cent band would be moved very sluggishly, thereby in effect narrowing the band in the short run. As he had noted previously, the exchange markets had been relieved that proposals for greater exchange rate flexibility had not been adopted. In that connection it was noteworthy that at the Copenhagen meetings Chancellor of the Exchequer Barber had not only rejected a floating exchange rate for sterling but had indicated that the United Kingdom would conform to the Common Market band.

In general, Mr. Coombs continued, there was little in the Common Market plan in its present form which should prove directly prejudicial to U.S. interests. However, the plan would lead to more frequent policy consultations among Common Market countries and perhaps to a progressively tougher joint stance against the United States in such matters as the further creation of SDR's and the treatment of dollar accruals. In the course of negotiating the new plan, moreover, a number of variants had been proposed, notably by French officials, which if accepted might well have damaging effects over time on the role of the dollar. Those alternative proposals seemed to have been shelved for the time being, but he thought they could easily command more general support in the Common Market at some later date if the United States continued to experience large deficits in its balance of payments. Those potentially damaging proposals envisaged a combination of the present plan to narrow the day-to-day band against the dollar with a significant widening of the ultimate limits over which the day-to-day band might move. Thus, the present outer limits of 1.5 per cent might be widened to the full 2 per cent permitted by the International Monetary Fund. Or an amendment to the Articles of Agreement of the Fund might be sought by the Common Market group which would permit a further widening of the outer band to, say, 4 per cent.

Mr. Coombs added that the basic issues involved were largely political. The avowed objective of the proposals in question was to reduce the dependence of the Common Market countries on the dollar by increasing the risks on holdings of dollars, both private and official, relative to those on holdings of European currencies. By thus altering the relative risk factors, it was argued, the Common Market could encourage flows within the Common Market of capital which now went into the Euro-dollar market and, more generally, lessen private demands for dollars within the Common Market. That, in turn, would reduce the need for official intervention in dollars and thereby enable the central banks of the Common Market to economize on their dollar holdings.

Ironically, Mr. Coombs observed, a number of U. S. officials had been attracted to the idea of such a widening of the band on the grounds that it might help to reduce destabilizing short-term flows and to promote revaluations of European currencies. As the Common Market countries moved towards closer financial integration, however, he thought they would be inclined to resist more and more firmly any revaluations forced upon them by deficits in the U.S. balance of payments. While many Europeans seemed sympathetic to greater exchange rate flexibility, it was increasingly his feeling that they did not envisage such a development in terms of more frequent revaluations of their own currencies, but rather in terms of adjustments by the United States. If the U.S. balance of payments deficits persisted, the situation might drift into a policy showdown between the United States and a unified Common Market, with attendant heavy speculation against the dollar. The potential for speculation on the dollar stemming from this issue appeared virtually unlimited, and he thought the Treasury had been well advised to take a cautious view on the whole matter of exchange rate flexibility.

Mr. Coombs added that the notion of an impending confrontation had apparently begun to be reflected in increased speculation in the London gold market. The price of gold had moved up rapidly in recent weeks to a level of $37.87 at the fixing this morning. While seasonal factors had contributed to the recent advance, it had persisted long enough to suggest that some more basic factors might be at work.

Mr. Hayes said he wanted to underscore Mr. Coombs' comment about the pressures in the Common Market to rally around measures designed to reduce Europe's dependence on the dollar and to reduce the risk of their being whipsawed by American policies. He thought the danger signals were up and should not be ignored.

Mr. Brimmer asked Mr. Coombs to elaborate on his comment that U.S. banks might repay as much as $2 billion of Euro-dollar borrowings before year end without creating difficulties.

Mr. Coombs said that figure represented his rough guess of the amount that could be repaid safely--in the sense that the United States would not have to resort to gold, SDR's, or a drawing on the Fund. He should note that he was assuming that the dollars would be accumulated principally by countries which could be expected to hold them or use them to repay debts, such as Germany, Italy, France, and the United Kingdom. The magnitude of the problem after the year end would depend, of course, on the size of the U.S. balance of payments deficit and the volume of repayments of Euro-dollar borrowings by American banks. In his view the situation would be particularly precarious if the present debtor countries in Europe had acquired enough dollars earlier to repay their debts and thereby joined such countries as Belgium and the Netherlands that were in a position to ask for settlement in gold or SDR's.

Mr. Brimmer observed that the net outflow of dollars before year end might well exceed $2 billion if indications given by American bankers with regard to their plans for repaying Euro-dollar borrowings were to be taken at face value. For example, one large New York bank had announced that it would reduce its participation in the Euro-dollar market by 50 per cent before year end and would repay some $700 million of borrowings in the process.

Mr. Robertson asked what the consequences might be if the balance of payments deficit in the fourth quarter approximated that of the third quarter and if, in addition, banks repaid as much as $5 billion in Euro-dollar borrowings.

Mr. Coombs replied that the consequences would depend importantly on which countries acquired the dollars. If a sizable portion were accumulated by countries that already had relatively large holdings, the System might initially have to make heavy drawings on its swap lines and those drawings might subsequently have to be funded through sales of gold or SDR's or through a Treasury drawing on the Fund. In his view, however, the balance of payments was likely to improve considerably from the third to the fourth quarters as a result of the large return flows of funds that could be expected in December, on the pattern of other recent years. Indeed, the current quarter might well provide the most favorable opportunity in the year ahead for financing large repayments of Euro-dollar borrowings by American banks.

In response to a question by Mr. Mitchell, Mr. Coombs remarked that the relationship between interest rates in the Euro-dollar market and those in the United States was a key element in the outlook for Euro-dollar repayments by American banks. To some extent those repayments could be self-limiting, if they depressed Euro-dollar rates sufficiently to remove the incentive for

American banks to continue making them. The course of Euro-dollar rates would depend in part on the policies adopted by various European countries. For example, today's reduction in the French discount rate no doubt would help to moderate pressures in the Euro-dollar market. On the other hand, if the United Kingdom maintained its current Bank rate, the British could expect to take in a large amount of dollars, a development he would regard as advantageous both to the United Kingdom and to the United States. There seemed to be a natural tendency for dollars to flow to countries with large debtor positions, since such countries were inclined to maintain relatively tight credit market conditions in order to attract dollars.

Mr. Hickman commented that there also seemed to be a tendency for interest rates to remain high in some countries with excessive dollar inflows--reflecting tight money policies designed to combat inflationary pressures produced in part by the dollar inflows. Although Germany was willing to accumulate dollars, it offered an example of a country with heavy inflows that was maintaining relatively high interest rates, presumably in anticipation of fiscal policy measures that would take up the anti-inflationary burden. He wondered if there was anything the United States could do to induce such countries to reduce their interest rates relative to those in the United States.

Mr. Coombs said he would have serious misgivings about trying to persuade other countries to adopt interest rate policies different from those they considered in their own best interests. In any event, there was much that individual countries could do to to insulate themselves from potential dollar inflows. For example, the Bank of France required French industrial borrowers and banks to secure official permission before obtaining funds in the Euro-dollar market. The German Federal Bank did not require such permission. If Germany chose to maintain a wide-open economy, it exposed itself to pressures from the Euro-dollar market--pressures which did not necessarily reflect developments in the U.S. balance of payments. While he suspected the German authorities were unhappy about their recent Euro-dollar inflows, he had not heard any criticism from German sources regarding U.S. monetary policy.

Mr. Hickman said that in light of the United States' important stake in the flows of dollars to Germany, it might not be inappropriate for this country to make a mild suggestion to the Germans that they adopt measures to moderate such flows.

Mr. Brimmer commented that the Germans had taken steps to limit dollar acquisitions by their commercial banks. However, he had understood during his recent visit to Germany that officials there did not have the authority to restrict the activities of other German borrowers in the Euro-dollar market. In connection with Mr. Coombs' report, he noted that the National Board for Prices and Incomes in the United Kingdom would expire in the near future, and he wondered if Mr. Coombs had information about any new machinery that might replace that Board.

Mr. Coombs said he suspected that Governor O'Brien's recent speech calling for an incomes policy to control inflation suggested that the Governor thought such a proposal would not necessarily be rejected by the Government.

Chairman Burns added that it was reasonable to expect a rather restrictive fiscal policy in the United Kingdom.

In reply to a further question by Mr. Brimmer, Mr. Coombs said that in its current limited form the plan of the Common Market countries to narrow the range of fluctuations in their exchange rates did not appear to have any serious implications for the System's swap network. Under the plan each central bank would continue to intervene in the exchange markets on its own initiative--though permitting a narrower range of fluctuations--and the System's swap lines would still represent bilateral arrangements. One question that did arise, however, concerned the stage at which the Common Market countries would begin consulting with the Federal Reserve and the Treasury regarding their exchange rate policies. Since the United States would be involved in the financing of operations designed mainly to maintain the narrower bands, he thought it was reasonable for the U.S. authorities to expect to participate in the discussions at an early stage.

By unanimous vote, the System open market transactions in foreign currencies during the period September 15 through October 19, 1970, were approved, ratified, and confirmed.

Mr. Coombs noted that two System drawings of $10 million each on the swap line with the Belgian National Bank would mature for the first time on November 5 and November 25, respectively. Since the Belgians would probably continue to take in dollars in the period ahead, he would recommend renewal of the drawings for further three-month periods. Should the Belgian authorities inquire, he would also propose to inform them that the System expected the drawings to be cleared up at the end of their second three-month terms.

Renewal of the two drawings on the National Bank of Belgium maturing November 5 and 25, 1970, was noted without objection.

Mr. Coombs said he would also recommend renewals for additional three-month periods of three System's drawings on the Netherlands Bank, maturing for the first time on November 10, November 17, and November 24, respectively, and totaling $145 million. The Dutch guilder was likely to remain strong in the period ahead and he saw little prospect that the drawings could be repaid in the near future. As in the case of the Belgians, he would propose to make clear to the Dutch authorities, if they inquired, that the drawings were expected to be cleared up at the end of a six-month period.

Renewal of the three drawings on the Netherlands Bank maturing November 10, 17, and 24, 1970, was noted without objection.

Mr. Hersey then presented the following statement on international developments:

> Now that the liabilities of U.S. banks to their foreign branches have been worked down to the May 1969 base level, this is clearly a good time to consider the prospects for the balance of payments over the next 6 or 9 months. In the past six quarters, from April 1969, the liquidity deficit before special transactions has totaled over $9 billion. This makes a very high annual rate, over $6 billion. It is customary to explain away about $2 billion of that as due to abnormal and largely unidentified outflows of private nonbank funds, presumably into the Euro-dollar market and into German marks and Canadian dollars. I do not feel so sure that we can call those flows abnormal, as we look ahead. But let me postpone that question for a few minutes.
>
> Without allowing for a disappearance of such outflows of funds, we may reasonably hope for a liquidity deficit before special transactions in the range of a $2 to $3 billion annual rate during the next two or three quarters.1/ (I shall not try to look beyond the middle of next year.) Over half of the improvement from the rate of over $6 billion in the past year and a half might reflect improvement in the goods and services balance, much of which has already occurred, and some of the rest would be due to an increase in foreign buying of U.S. equities, which has resumed in the past four months. The projection assumes that the interest equalization tax will continue to prevent U.S. investors from buying the outstanding Euro-bonds of U.S. companies, and that the program of the Office of Foreign Direct Investment will keep up the pressure on companies to borrow abroad. On the other hand, we may have to assume that U.S. banks will use more of their existing leeway under the voluntary foreign restraint program as credit conditions ease.

1/ After the meeting Mr. Hersey informed the Secretary that projections of capital flows made the same day by an interdepartmental committee suggested that a rate of liquidity deficit as low as this could not reasonably be hoped for.

With regard to the current account: if you were trying to estimate what you might call a "full employment balance of payments" you could take little comfort from the fact that net exports of goods and services are now running at nearly a $5 billion annual rate, against an average not much over $3 billion in the past year and a half. The improvement has occurred during a period of slow growth and increasing slack in the U.S. economy, while abroad some countries have been experiencing really extraordinary boom conditions. But in the short perspective of a look at the next few months, we can reasonably expect some further gain.

Very preliminary estimates for September trade, which were not available in time for the green book, 1/ are reassuring. Imports, after looking disturbingly large in August, were down in September, and the staff projections for the domestic economy imply a fairly flat level for imports for a few months ahead. Exports, on the other hand, were temporarily flat in August and September, largely on account of a sharp reduction in commercial aircraft deliveries. A renewed advance in total exports is expected.

Projections of exports depend heavily, of course, on an assessment of demand conditions abroad. Apart from Canada, in none of the other major industrial countries do we find a real pause or recession beginning yet. It is true that a general easing of supply and demand conditions for steel and nonferrous metals began to develop early this year, but this has reflected a cessation of inventory buildup rather than any decline in final use of metals. It is also true that in almost every country but Japan, industrial production leveled off in the second quarter, after long-continued advances--but this was at least partly a result of tight labor supply and squeeze on capacity in industries not affected by the slowing of inventory demand. Finally, it is true that in Germany and some other countries where demand pressures have been the most acute, new orders for machinery have at last passed their peak. Against all this, two other sets of considerations are particularly relevant for the U.S. export prospect. First, the still very large backlogs of unfilled orders for capital equipment and the still high levels of new orders coming to producers in Germany and some other

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

countries seem to promise further demand for U.S. exports while existing export order backlogs here are being worked on. Second, sharp increases in labor income are taking place virtually everywhere and seem to be sustaining strong demands for consumer durables. This may not directly benefit U.S. exports of those particular goods, but it may help keep aggregate demand abroad strong enough--at least in the next few months--to prevent the inventory cycle in materials from fathering a general pause such as occurred in 1966-67 or in 1957-58.

Now I come to the question of outflows of liquid funds, and to another question closely related: What is going to happen to U.S. banks' liabilities to their foreign branches?

The answers to both questions depend partly on how willing European monetary authorities will be to allow their short-term interest rates to fall. It seems likely that a country in Britain's position, anxious to protect its reserves while encouraging domestic expansion with other measures, will delay reducing sterling interest rates so as to encourage switching of funds into sterling as Euro-dollar rates ease off. In countries where the central bank, as in Germany, is determined to squeeze the liquidity of the banking system in order to help check inflation, the answer is not quite so clear. The German Federal Bank is now counting on steep marginal reserve requirements on increases in bank deposits--raised at the beginning of September to as much as 40 per cent for the big banks on all their time liabilities other than savings deposits as well as on demand deposits--to mop up a good part of the bank reserves that would be generated by any capital inflow. This may allow a coexistence of high interest rates in Germany, inflows of funds, and a liquidity squeeze. On the whole, I consider it likely that European national interest rates will continue to lag behind the decline in Euro-dollar rates, causing them in turn to lag behind the decline in U.S. short-term market rates. Euro-dollar rates will therefore continue to attract U.S. investors and will push U.S. banks into repaying much more of their liabilities to branches.

Two banks have quietly given up a part of their reserve-free bases, and one bank has let the world know that it plans to repay a substantial part of its borrowings. Others may wait to see if this makes Euro-dollars appreciably cheaper. Also, thoughts of the possibility of a new Regulation Q squeeze on CD's a year or more ahead still restrain most banks from a precipitate surrendering of their reserve-free bases. How long this caution will persist I do not know.

Once a general move to repay more gets under way, questions of confidence in currencies may arise in the marketplace again. These questions may take the form either of doubts about the dollar and the price of gold or of runs into currencies thought likely to appreciate, or both.

To sum up, there is a wide range of possibilities for the official settlements deficit in the two or three quarters ahead. For example, repayments to branches might amount to $5 billion, taking the total down to what it was in the spring of 1968. In that case we should expect further outflows of private nonbank funds motivated by interest rates and by exchange rate fears. That could cost us an official settlements deficit of $7 or $8 billion. Coming on top of the $7 billion in the first three quarters of 1970, such an outcome might seriously undermine international cooperation in the Fund and G-10. At the other extreme, we might conceive of a combination of circumstances in which U.S. banks gradually repay no more than $1 or $2 billion in the next 9 months and there is no net outflow of private nonbank funds either into Euro-dollars or to hedge against currency appreciations. In that case, the liquidity deficit might vanish and the official settlements deficit might be no more than $1 or $2 billion. But such a result can hardly be conceived of unless European central banks are able and willing to reduce their short-term rates appreciably, and soon, which on the whole seems unlikely. If interest rates here continue to decline, and if the banks lose their fear of another squeeze on CD's coming some day, they are likely to go on with their repayments of liabilities to branches--unless some special new means of persuasion can be devised.

Chairman Burns said he could add one word of reassurance. Work on the balance of payments problem was going forward actively, and he was confident that adequate means for grappling with that problem could be devised.

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

Mr. Partee made the following statement concerning economic developments:

The general impression conveyed to me by the broad array of recent economic data is that the performance of the economy, even before the General Motors strike, was somewhat weaker than we had been expecting. Most notably on the weak side have been the labor market statistics. Private nonfarm employment continued to edge down from month to month over the third quarter, initial claims and insured unemployment have been rising again since mid-summer, and renewed labor force growth brought a sharp rise in the over-all unemployment rate in September. But sales have also continued exceptionally sluggish at retail, while business inventories showed surprising amounts of accumulation in July and August. Industrial production has continued to decline, with the reduction in September fairly sizable and extending well beyond the automobile industry.

Preliminary Commerce estimates for the third quarter, of course, do show some pickup in growth of both real and current dollar GNP. But it must be remembered that these first estimates are made without the benefit of September figures in many key areas, and that the tendency recently has been for the underlying data to be revised down. The gains in activity shown are very small, moreover, and the composition of the reported GNP expansion is on the weak side. Thus, private final purchases are estimated to have risen less in the third quarter than in the second, and inventory accumulation is thought to have increased even after a $2 billion deduction to allow for the initial third-quarter effects of the GM strike. Assuming that real output did increase at around a 1-1/2 per cent annual rate in the quarter, however, a sharp gain in productivity is implied, since private nonfarm manhours worked declined at about a 3.5 per cent annual rate.

In the GNP accounts, business spending on capital equipment is estimated to have increased slightly in the third quarter on a current dollar basis. This contrasts with the production index, where physical output of business equipment is shown to have declined by 3 per cent, on average, between the second and third quarters. Although allowance must be made for price change and the seasonal factors in the two series may differ, the differences in movement seem too large to be reconciled. Our monthly production measures in this area are based mainly on manhours plus a productivity allowance. But the decline we have shown seems broadly consistent with the downtrend in other inputs, including steel shipments to the capital goods industries and electric power consumption, and with related measures of activity such as new orders and the square footage of commercial and industrial floorspace in construction contract awards. According to the production index, output of business equipment is now off 10 per cent from last fall's peak, only a minor part of which is attributable to the partial September loss of GM truck assemblies.

More generally, it is exceedingly difficult to see any basis for expecting strength in business capital spending over the next several quarters, except in the utilities, communications, and mining industries. Current capacity utilization rates in manufacturing are down to 76 per cent, the lowest in many years. Replacement demands for new equipment also seem likely to have been dampened by termination of the investment tax credit and probably by a leveling off in expected rates of gain in employee compensation, increases in which over the past several years have given a boost to installation of labor-saving facilities. Corporate profits and retained earnings are down substantially in many industries, external funds are still costly and difficult to obtain for all but the best credit risks, and there is renewed emphasis on financing related to improvement in corporate balance sheets rather than to fixed investment. Finally, business generally seems to anticipate only modest growth in demand next year, so that there is little incentive to hasten capital spending programs now in order to take advantage of market opportunities later on. Under these circumstances, it seems to me likely that manufacturing and commercial investment spending will continue to decline, quite possibly offsetting or more than offsetting increases in the public utility sectors.

Consumer spending, on the other hand, should sooner or later begin to improve. The personal saving rate is relatively high and consumers have increased their takings of goods very little in real terms over the past two years. So far, however, there is little or no sign of improvement in this area. Retail sales, exclusive of autos and building materials, have remained essentially flat for the past six months. The third-quarter rise in consumption was the smallest since 1968, despite appreciable acceleration in estimated service outlays. Recent attitudinal surveys indicate that there has been some recovery in consumer psychology, although it remains at a historically low ebb. Savings inflows to the depository institutions have continued extremely high, which is good for housing--where starts and building permits increased significantly in September--but not so favorable an omen for sales. The danger, of course, is that sluggish spending will force further employment curtailments and destroy prospective growth in incomes.

In this regard, recent labor market developments seem to me most ominous. Third-quarter nonfarm employment, on average, dropped by 436,000 from the second quarter--the largest quarterly decline thus far in the current cycle. The decline in factory-worker employment tended to slacken, and for September preliminary estimates show no net reduction at all. But manufacturing employment in nonproduction jobs--essentially office and sales staffs--continued to drop in September for the seventh consecutive month. And employment in private nonmanufacturing activities has continued to fall, with declines in the third quarter spreading to trade, finance, and services. Altogether, total nonproduction jobs in September were at the lowest level of the past year. This is where we normally look for much of the expansion in employment to absorb continuing growth in the labor force. But with sales sluggish and profits pinched, the outlook for renewed substantial growth in this broad area--quite aside from possible cyclical recovery in factory employment--seems to me in some doubt.

In sum, I am impressed by the underlying weaknesses evident in the economy over recent months. The outlook in major areas--capital spending, retail trade, business inventories, labor markets--appears to me cloudy, with plenty of room for uncertainty as to the strength of recovery in prospect. We are planning to present a full-scale economic projection to the Committee at its next meeting, giving our first impressions of prospects for all of calendar 1971 and evaluating these and other problem areas. At present, however, it appears to me that we are likely to need all of the encouragement of investment that we can get--including business as well as housing and public facilities projects--in order to assure resumption of economic expansion along a moderate but acceptable growth path. Toward this end, I would consider a more pronounced downtrend in long-term interest rates the most constructive single condition to be sought in financial markets. With the calendar crowded by refinancing issues and at the present pace of monetary expansion, however, it seems to me doubtful that such a trend is likely to develop in the weeks immediately ahead.

Mr. Axilrod made the following statement concerning financial developments:

Financial markets continue to reflect a strong demand for liquidity on the part of key economic sectors. In the third quarter, this occurred in the context of a decline in the net amount of funds raised by private sectors of the economy, according to very preliminary flow-of-funds estimates. Nonfinancial business corporations, however, sustained their efforts to restructure their balance sheets and reduce reliance, relatively, on short-term debt. In the corporate bond market, the extremely large volume of new issues apparently will continue at least until the December period of seasonal slack, and by the time the year is over the volume of new public bond offerings in 1970 is expected to total almost twice that of 1969. This burgeoning of the new-issue volume occurred at a time when corporate spending on plant and equipment was leveling out and when the gap between total capital outlays and internally generated funds was receding, though constraints on profits have contributed to keeping the gap high. With the evidence pointing to a further moderation in capital outlays next year, the large volume of corporate bond offerings appears to reflect mainly a desire to avoid additional bank debt or to repay such debt.

As business credit demands have shifted from short- to long-term markets, banks have been better able to improve their own liquidity positions. Outstanding business loans of banks, adjusted for loan transfers between banks and their affiliates, have shown little net change over the past two months, and for the year to date have increased at an annual rate of 4-1/2 per cent, or only about one-third as much as in 1969. As demands for business loans have slowed, banks have, of course, placed the bulk of their greatly increased flow of deposits in short-term liquid instruments as well as repaying short-term indebtedness in the Euro-dollar market, the commercial paper market, and with the Federal Reserve. It is worth mentioning that apart from a special situation which accounts for about $275 million of member bank indebtedness to the Fed, normal use of the discount window has dropped sharply over the past four months to an average of only about $150 million in the last two weeks.

Another element in the improved position of banks is the more assured flow of deposits consequent on the suspension of Regulation Q in the short CD maturity area, on the movement toward competitiveness of all CD's as a result of further declines in short-term market rates over the past month, and on the sustained inflow of time deposits other than CD's at about a 15 per cent annual rate since midyear. This latter growth, which seems to represent mainly a buildup in consumer savings, extends to country and nonmember banks as well as to the large city banks also active in the CD market.

The sizable rate of inflow of consumer time deposits at banks in the third quarter has been paralleled by a 9-1/2 per cent rate of gain at savings and loan associations and mutual savings banks. The further improvement in inflows to S&L's has encouraged these institutions to moderate borrowings from Home Loan Banks and add to their own holdings of liquid assets. In addition, the Home Loan Banks themselves have remained highly liquid, holding a sizable stock of liquid assets as the need for supplementary mortgage market funds has abated.

The strong and persisting demands for liquidity explain why short-term interest rates have been easier to bring down than long-term rates. Since mid-September short-term market rates have dropped another 30 to 60 basis points, but long-term rates have been quite sticky. Treasury coupon issues have come down 5 to 10 basis points, and mortgage yields have dropped similarly, but municipal yields have drifted up a little and corporate new issue yields have been virtually unchanged on balance.

From the viewpoint of demands for longer-term securities, however, we may be near the point where yields could come down a little more noticeably. The improved liquidity position of thrift institutions has increased their willingness to undertake mortgage commitments. And banks, too, have shown some signs of interest in mortgages and longer-term Treasury and municipal issues. Moreover, investors generally appear to be fairly willing purchasers of bonds, though remaining selective.

On the other hand, the supply of new longer-term issues will be very large for a while. The large State and local government volume may anticipate a somewhat greater rate of spending, but the corporate volume seems to reflect in good part a willingness to pay quite high interest rates as a necessary cost of restructuring debt. And the Treasury refunding, to be announced Thursday, is of course essentially a debt restructuring operation, with the Treasury expected to include a long-intermediate option in the offering.

This sizable supply of intermediate- and longer-term securities in the offing makes it uncertain how soon or how far, or for that matter whether, long-term rates will drop. And declining long-term rates seem needed, as Mr. Partee noted, for economic reasons--in order to encourage even more State and local spending, to accelerate the availability of funds for mortgages and to increase demands for housing credit, and generally to bring market rates more in line with the apparently reduced real rate of return on capital.

As a means of seeking to establish, or to accelerate in time, some downward momentum in longer-term rates, the Committee might wish to consider a program of sustained buying of Treasury coupon issues as a means of providing reserves--buying such issues in significant volume whenever reasonably feasible in this fall period of seasonal reserve supplying operations. It may even be possible to make room for such purchases by selling Treasury bills if demands for liquidity remain sizable and if as a result this can be accomplished without exerting significant upward pressure on short rates. Emphasis on the long-term area in reserve supplying operations would have the side effect of keeping short rates from declining as much as they otherwise might and, thereby, would be of marginal benefit--probably quite marginal--in keeping banks from increasing the flow of dollars abroad by repaying Euro-dollar borrowings further.

This coming Treasury financing period, of course, affects the possibilities of near-term operations in coupon issues as well as the possibilities of altering

> money market conditions. The coming financing period--with the Treasury announcement on Thursday, books open in late October, and settlement date at least for the refunding on November 16--virtually blankets the interval between this and the next FOMC meeting. But some inroads have been made, I believe, in a strict interpretation of even keel over the past year.
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> The Treasury financing schedule this time leaves an unusually long 2-1/2 week period between the time when books are closed and when the refunding is to be settled. I do not believe open market operations need remain inflexible over that period. With respect to operations in coupon issues, these might have to be minimal--although purchases of securities maturing in the very long-term area could be more obviously undertaken if they were available than purchases of securities in maturity areas close to the new offerings. With respect to the money market, though, I would suggest that conditions could move within a reasonable range if that were necessary to maintain the aggregates on a path desired by the Committee. The reasonable range could be defined at least as the range of money market conditions over the past four statement weeks. That range would encompass a 5-3/4 to 6-1/2 per cent Federal funds rate and a net reserve position for member banks varying from near zero to a negative $500 million.
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> On this reasoning, the Committee would have scope to keep on a path leading to a 5 per cent growth rate of money over the fourth quarter even if that seemed to require some near-term easing or tightening of the money market from the experience of recent days. Indeed, if it chose, I believe the Committee might also have scope to work toward a somewhat more rapid money growth.

Mr. Holland reported that information had just been received indicating that Euro-dollar rates on the shorter maturities had declined sharply further today. Rates were now 4-1/4 per cent on overnight funds; 5-1/2 per cent on call deposits; 6-13/16 per cent on 30-day deposits; and 7-5/8 per cent on 90-day deposits. The last of these was 11/16 below its level of a week ago.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period September 15 through October 14, 1970, and a supplemental report covering the period October 15 through 19, 1970. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Holmes commented as follows:

> As the written reports indicate, short-term interest rates declined over the period since the Committee last met, as banks added substantially to liquidity and private corporations continued efforts to restructure their debt. Reflecting these efforts, yields on corporate bonds were little changed over the period as a whole, as an exceptionally heavy calendar of new issues prevented more than short-lived movements toward lower rates. Yields on short-term tax-exempt securities declined as banks were heavy buyers of issues with maturities of up to ten years or so. Yields on long-term tax-exempt bonds, however, edged a bit higher.
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> In yesterday's regular Treasury bill auction average rates of 5.94 and 6.12 per cent were established on the new 3- and 6-month bills, in each case down 37 basis points from the rates established in the auction just preceding the last meeting of the Committee.
>
> Money market conditions fluctuated fairly widely over the period, but the generally more comfortable tone--reflected in a lower Federal funds rate and reduced bank borrowing at the discount window--was an important factor contributing to the general decline of short-term interest rates. With the economy continuing to act sluggishly, most market participants tend to anticipate some further declines in rates. However, the heavy demand for long-term funds, the Federal budget deficit, and nagging fear on the part of some market participants that monetary growth this summer has been excessive and will have to be cut back by the Federal Reserve are inhibiting factors.

Open market operations over the period had to contend with unusual and unpredictable swings in market factors affecting reserves--especially float--and with a rather peculiar pattern of reserve management by the commercial banks. Early in the period, the money market turned quite easy, with the Federal funds rate and the three-month bill rate declining below the discount rate and leading to expectations that the discount rate would be lowered--particularly after the reduction of the prime rate on September 21. This tendency towards undue ease was resisted vigorously through open market operations, but the market was slow to respond. In contrast, in early October the money market tended to be unduly firm, with Federal funds trading at 6-1/2 per cent or above, despite an apparently ample reserve availability. This tendency, too, was resisted by supplying reserves liberally through open market operations. And, as you will recall, a daily-average free reserves figure emerged for the week ending October 7, when excess reserves were abnormally high--the first such figure since the week of February 14, 1968. While the emergence of free reserves caused some raised eyebrows in the market, the reaction was relatively mild--reflecting the fact that the market has recently been paying less attention to net borrowed reserves as a measure of System intentions.

As far as the aggregates are concerned, money supply turned out to be stronger in September than expected, bringing the third-quarter growth rate to a 5 per cent annual rate, a result that seemed highly unlikely at the time of the last meeting. Current projections--based on the continuation of recent money market conditions--point to a similar rate of growth for the fourth quarter. This is in line with the blue book[1/] path at the time of the last meeting, although the monthly pattern looks quite different now than it did then. The December level of the money supply is now $900 million higher than the September 15 blue book path, reflecting the fact that September turned out stronger than expected. Projections of the credit proxy over the fourth quarter have moved somewhat erratically in the past few weeks, as banks continue to build up deposits--including large-denomination CD's--and to reduce their borrowings through commercial paper and Euro-dollars.

As the written reports indicate, rates on CD's of all maturities are now below the Regulation Q ceilings for the first time since early 1969. At the moment it is not clear whether this new-found ability to attract

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

deposits will result in a rapid expansion on the asset side or in a further pay-down of nondeposit liabilities. With business loan demand weak--reflecting the restructuring of corporate debt in the long-term markets--banks will be facing some major investment decisions. So far they have been stressing liquidity, but they have been moving out to the 10-15 year maturity area in tax-exempt bonds, while the forthcoming Treasury refunding will provide a significant test of their appetite for intermediate-term Treasury securities.

Staff projections of a 9-10 per cent annual rate of growth in the proxy for the fourth quarter as a whole are not far different from the blue book path at the time of the last meeting, although projections have weakened over the past two weeks. However, the projections are unusually uncertain since much will depend not only on bank portfolio decisions but also on bank decisions with respect to the maintenance of reserve-free Euro-dollar bases and other nondeposit sources of funds. At the last meeting of the Committee the credit proxy was added to the directive but clearly in a role very subsidiary to money supply as an interim guide to open market operations. In the draft directive before the Committee1/ the credit proxy is continued in that role and I would find it helpful to have the Committee's views on how much or little open market operations should be affected by significant deviations of the proxy from current staff expectations.

As you know, the Treasury will be announcing later this week the terms of its November refunding of $7.7 billion notes maturing on November 16. The stage appears to be set for a very successful operation--given appropriate pricing--with rights trading at an unusually high premium. The market generally expects the Treasury to offer holders of the maturing issue the right to exchange for two new notes in the 3- to 7-year maturity range, and to cover attrition and perhaps raise some new cash by a cash auction of a short-term note or tax-anticipation bills. Interest in the refunding on the part of banks and dealers is high, although bank participation may be affected somewhat adversely by the Treasury's newly announced "early closing" for subscriptions. There is some risk that a speculative interest may develop, although activity by nonprofessionals would be limited if an exchange refunding is used. Open market operations in the period ahead will, of course, have to be conducted

1/ Appended to this memorandum as Attachment A.

with close attention to the state of the Treasury financing.

The System holds $1,187 million of the maturing 5 per cent notes, and I would plan to exchange these for whatever issues the Treasury offers in the refunding in proportion to the expected public subscription. This would mean that the System would not participate in any subsequent auction of a short-term security, if that in fact is what the Treasury decides upon.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 15 through October 19, 1970, were approved, ratified, and confirmed.

Mr. Hickman said he agreed with Mr. Axilrod regarding the desirability of reducing long-term interest rates, and he was not opposed to the latter's proposal for sustained buying of coupon issues. However, he had some reservations about the over-all effectiveness of the proposal because it would tend to constrain declines in short-term rates. Relatively high short-term rates in turn would tend to have adverse effects on the investment activities of life insurance companies and banks, the most important "swing" investors in key intermediate- and long-term debt markets. Life insurance companies were being squeezed by the large volume of policy loans that resulted from the current level of short-term rates, and to restore their liquidity, rate declines of perhaps 1/2 to 3/4 of a percentage point would probably be required. Similarly, relatively high short-term rates made it more difficult for banks to attract CD funds and thus tended to limit their participation in the market for municipal securities.

Mr. Mitchell asked Mr. Axilrod to comment on the probable magnitude of the proposed purchases of coupon issues and on the channels through which he would expect such purchases to affect long-term rates.

Mr. Axilrod replied that it was hard to be specific about the magnitude of the operations since it would depend to an extent on the availability of coupon issues in the market. He might note, however, that the System would be faced with the need to supply a relatively large volume of reserves in the period until the year end--perhaps on the order of $2 billion to $2-1/2 billion. As to channels of effect, he would expect long-term rates to be affected to some--probably minor--extent simply by the reduction in the market supply of long-term issues caused by System purchases. More importantly, a sustained program of such purchases--in amounts of $50 million or $75 million at a time--would indicate to the market that the System was interested in fostering a reduction in long-term rates. That, in turn, should have a favorable effect on the willingness of investors to purchase and hold long-term securities, particularly in the present atmosphere in which there was a general view that the trend in long-term rates would be downward were it not for the continuing heavy volume of new issues in capital markets.

In reply to a request for comment, Mr. Holmes said he did not think the coming policy period was a good time for the System to buy coupon issues, in light of the forthcoming Treasury financings. He agreed that such purchases would be desirable later in the year, and he thought the Desk would be undertaking them at that time in the normal course of events. There might be a need for caution, however, to avoid depressing rates on long-term Governments so low relative to those on corporate securities as to cause pricing problems for the Treasury in future financings.

Mr. Mitchell expressed the view that the Desk would have to buy coupon issues more aggressively than in other recent years if the objectives Mr. Axilrod had described were to be accomplished.

Mr. Holmes agreed, and noted that the matter was one for the Committee to decide. In that connection he recalled that it had been concluded in the recent Federal Reserve-Treasury study of the Government securities market that the System normally should not engage in swap operations, simultaneously selling short-term securities and buying long-terms, and that the volume of long-term securities bought by the System normally should be modest relative to the volume available.

Mr. Axilrod said he would like to clarify one aspect of his proposal. He concurred in the view that it would be undesirable for the System to purchase Treasury securities within a maturity range of, say, 18 months to 10 years during the coming policy period, in which Treasury financing operations would be in process. It might be possible and desirable, however, to purchase Governments with maturities of more than 10 years. Admittedly, only a relatively small volume of such issues was normally available in the market, although the availability would be increased to the degree that market participants thought it desirable to sell long-term Governments to buy corporate bonds. He thought it would be useful to take advantage of any opportunities that might arise in the coming period to buy very long-term Governments.

Mr. Holmes commented that while he would not rule out the possibility of such purchases by the System, he thought they might have an undesirable degree of visibility.

Mr. Brimmer noted that some overtones of speculative activity were already appearing in the market. He asked whether sustained System purchases of coupon issues might not provide further encouragement to speculation.

Mr. Holmes expressed the view that under existing circumstances there was a real risk of unleashing a large volume of speculative activity, with consequences that might be hard to unwind later.

Mr. Brimmer remarked that if the Committee were to instruct the Manager to begin buying long-term Treasury issues later in the year it might also want to consider instructing him to buy agency issues. Perhaps the staff should be asked to prepare a memorandum covering both possibilities for review by the Committee at its next meeting.

In response to questions, Mr. Brimmer said he was not suggesting any particular maturity range for possible purchases of agency issues, nor was he proposing that the objective of any such purchases be limited to stimulating housing activity. The objective he had in mind was the same as that which Mr. Axilrod had associated with his proposal--to encourage declines in long-term rates generally. He also should make it clear that he was not recommending another fundamental study of the desirability of outright System operations in agency issues, such as had been included in the recent Government securities market study. In the course of deliberating on the results of that study the Committee had decided four years ago to authorize repurchase agreements in agency issues, but it had not reached any final conclusion with respect to outright operations; he was proposing simply that it now face up to the latter issue. Perhaps it would be useful for the staff memorandum he had suggested to focus on a very limited time span, such as the last six weeks of 1970.

Mr. Hayes agreed that both Mr. Axilrod's proposal and the possibility of outright purchases of agency issues warranted Committee consideration. However, since the former seemed more germane to current policy problems, the staff might be instructed to give it precedence in any new analyses it was asked to prepare.

The Chairman said he thought that the staff should be able to consider the pros and cons of both issues. Also, in his judgment it would be desirable to focus on a period longer than the six-week span Mr. Brimmer had mentioned.

Mr. Kimbrel asked Mr. Axilrod to elaborate on the concluding comment in his prepared statement, to the effect that the Committee might have scope within the coming policy period to work toward a growth rate of money somewhat more rapid than the 5 per cent path outlined in the blue book.

Mr. Axilrod said he thought that it would be technically feasible in the coming even keel period to move the Federal funds rate below 6 per cent and that such a reduction in the funds rate might be consistent with growth in money over the fourth quarter at an annual rate of about 6 per cent. Indeed, it might even be needed to sustain a 5 per cent growth rate. But he had made the point particularly to indicate to the Committee that a move toward a growth rate of money somewhat higher than 5 per cent was possible despite the even keel considerations affecting the next four weeks. He personally thought such a higher growth rate was desirable.

Mr. Eastburn observed that inflationary expectations were often said to contribute to high interest rates. He asked whether a vigorous System program to reduce long-term rates by buying coupon issues might not have the perverse effect of raising rates by restimulating inflationary expectations.

Mr. Holmes remarked that in his judgment there was a good possibility of such an outcome. He noted that many people in the market were already of the view that the System had fostered excessive growth in bank credit during the summer. Such people were likely to interpret a vigorous program of purchases of coupon issues as further evidence that System policy was unduly expansive. Portfolio managers might decide as a result that inflationary forces were likely to lead to higher interest rates, and that the present, consequently, was not a good time to buy long-term securities. Such decisions would, of course, tend to exert upward pressures on rates.

Chairman Burns observed that some market participants no doubt would reason in such a fashion. However, at a time like the present--when the unemployment rate was 5.5 per cent and perhaps tending higher--he wondered whether enough market participants would do so to push long-term rates upward.

Mr. Holmes agreed that the probability of such an outcome would be reduced to the extent that weakening economic demands were exerting downward pressures on rates.

Mr. Hayes remarked that there seemed to be a close balance at present between people who expected the economy to weaken and viewed unemployment as the most pressing immediate problem, and people who considered inflation still to be the dominant danger. While it was a matter of judgment, he had the impression that the majority of people in the financial and business communities, at least in New York, held the latter view.

The Chairman observed that that subject had been discussed at length at the recent meeting of the Business Council, which he had attended. There was no question but that the great majority of business leaders were fearful of further inflation. However, it was clear at the meeting that that fear focused on a time period 18 to 24 months from now, and that it reflected the growing size of wage increases being agreed upon in current collective bargaining agreements rather than the view that monetary policy was likely to be unduly expansive. It was because of that longer-run concern that business leaders were strongly urging the adoption of an incomes policy. For the next year or two their main concern was with unemployment; they thought the pace of inflation would be slackening under the influence of policy. He could not comment as confidently on the attitudes of bankers, since he had not had sufficient opportunity to hear their views on this specific distinction.

Mr. Hayes then said he might comment on the general business situation. He agreed with Mr. Partee that activity was more sluggish than had been expected a month or two ago, even after allowance was made for the General Motors strike. He still thought, however, that the underlying situation had important elements of strength. Housing activity and State and local government spending were responding to the easier conditions that had developed in financial markets. The inventory situation was mixed, but a severe inventory drag such as that of last winter did not seem likely. While consumer spending was sluggish, the currently high rate of personal saving contained the makings of a pickup. The current downward revisions in business spending plans were likely to result in a more moderate rise in that sector rather than in a sharp decline. Admittedly, the present level of the unemployment rate was disturbing. But he was also disturbed by the assumption that seemed pervasive in official circles that a 4 per cent unemployment rate was the proper objective at all times; the question could be raised as to whether so low a rate did not reflect over-employment in times of inflationary pressures. While the present 5.5 per cent level of unemployment and the possibility of still higher rates obviously was a matter of concern, a prolonged period of unemployment rates somewhat higher than had prevailed in recent years might be necessary if inflation were to be brought under control.

While the price situation was beginning to look better, Mr. Hayes continued, he was not at all sure the latest figures meant that inflation was coming under control. The cost picture also seemed to be improving as a result of productivity gains, but that might be only a short-run cyclical development. In brief, he was not convinced that prospects were for a continuing abatement of inflationary pressures. He shared the concerns of businessmen, as the Chairman had described them, regarding the implications of current wage settlements for inflationary pressures in the future. But he thought part of the current unease in the business community reflected the fear that stabilization policies might be relaxed so much in the effort to reduce unemployment that they would contribute actively to further inflation.

Mr. Maisel remarked that Mr. Hayes' comments regarding the appropriate unemployment rate served to reinforce his own belief that at least some of the Committee's differences on policy reflected differences in basic value judgments regarding the relative importance of various conflicting goals--for example, regarding the appropriate trade-off between employment and price stability. He thought it would be useful for the Committee to plan on discussing the basic goals of monetary policy at some point, in order to clarify the nature of the differences of view on such matters as that to which Mr. Hayes had referred today.

The Chairman agreed that such a discussion would be useful. He thought it would be worthwhile to explore not only the views of Committee members but also those of society at large, as reflected in the judgments of members of Congress, senior officials of the Administration, and others. For example, Committee members might agree that under current conditions a 5 per cent unemployment rate was preferable to a 4 per cent rate. However, if that view was out of line with the thinking of the rest of the Government and of society generally, the members should be aware of that fact.

Mr. Maisel concurred in the Chairman's observation. He then said he had a technical question about the proposed purchases of coupon issues which perhaps could not be answered without some study. It seemed to him that one basic consideration related to the effect such purchases could be expected to have on the monetary aggregates which the Committee employed as targets. Presumably, accomplishing the desired restructuring of interest rates would affect the demand and supply schedules for bank deposits, and that in turn would change the volume of reserves needed to get a specified change in the aggregates.

Messrs. Axilrod and Holmes agreed that a proper answer to Mr. Maisel's question would require further study.

In response to a question by Mr. Coldwell, Mr. Partee said that at the moment he did not think a cumulative downturn in economic activity was under way. As he saw it the process was one of attrition, with some risk of taking on cumulative aspects. For example, the currently very high saving rate might conceivably decline not as a result of higher consumer spending but because of a slowing of the rise in income--reflecting, in turn, the reduction in "marginal" hiring that now was occurring in many industries besides manufacturing.

Mr. Partee went on to note that the staff's projections of modest increases in economic activity in 1971 had been based for some time on an assumption of a pickup in consumer spending. It was his fear that the underpinnings of that pickup might now be crumbling.

Mr. Coldwell asked whether the projections of consumer spending took account of the large stock of financial assets that consumers could draw on as a partial offset to a slowing of income growth.

Mr. Partee replied that in preparing the latest revisions of the GNP projections explicit account had not been taken of the recent rapid rise in financial savings in various fixed-value forms. If that were done, however, account also would have to be taken of the value of consumers' holdings of equities; as the Committee knew, indexes of common stock prices were still down substantially on balance over the last year. He was not sure of the net impact on the financial position of consumers recently.

Mr. Coldwell then asked whether Mr. Partee would expect economic activity to remain generally weak even if the auto strike were settled soon.

Mr. Partee responded that the personal judgment regarding the outlook that he had expressed was based largely on economic data relating to the period before the auto strike. Thus far, the strike had not had an impact deep enough to affect the fundamental forces at work in the economy; if it ended soon its main effect would be to shift some part of aggregate activity from the fourth quarter to the first. Of course, the strike was not helping the economy; and if--as some were now suggesting--it lasted a relatively long time, it undoubtedly would have an adverse influence on consumer attitudes as well as on income flows.

Mr. Galusha referred to Mr. Axilrod's proposal relating to coupon issues, and said he suspected that some members of the Committee were assuming that the recommendation was for a much broader move into the coupon market than in fact was the case. As he (Mr. Galusha) understood it, a fairly cautious move was proposed in the expectation that it would have some effect on rates--both through its direct market impact and through its effects on psychology. In his judgment effects of both types were needed. Corporate liquidity was dangerously low, some major companies were having difficulty in paying their bills, and business failures were increasing. Such circumstances could produce fears of a liquidity crisis similar to those following the Penn Central insolvency, to which the Committee had been forced to pay a good deal of attention this past summer. A cautious venture along the lines of Mr. Axilrod's proposal should serve two salutary purposes--that of improving supply and demand conditions in the long-term market at least marginally, and that of allaying existing concern in the business community about the System's attitude toward this particular problem.

Mr. Swan said he agreed with Mr. Partee's analysis of the economic situation. He might note that the unemployment rate in the State of Washington had now risen to 10 per cent, largely reflecting the slowdown in the aerospace industry. Unemployment was up again in California also. In Oregon, which was more heavily oriented toward lumbering, the rate had been stable from August to September.

Mr. Swan went on to say he agreed that a decline in long-term rates would be desirable. However, it was worth noting that a large volume of funds had been flowing into the home mortgage market recently, at the same time that capital markets were absorbing a heavy volume of new offerings--all without increases in long-term rates. The performance of the financial markets thus appeared to have been quite satisfactory. In that connection, he wondered how the staff viewed the outlook for the volume of new offerings in capital markets.

Mr. Axilrod replied that--setting aside December, when offerings typically were seasonally low--the staff expected demands for funds in the corporate bond market to slacken early next year. On the other hand, demands in the municipal market were likely to continue high for some time; they would have to be high if spending by State and local governments was to strengthen to the extent anticipated.

Mr. Axilrod added that in his judgment long-term rates wanted to decline, but the heavy corporate calendar was acting as an impediment. Under those conditions he thought sustained System purchases of coupon issues would be successful in fostering or accelerating a decline. Had the situation been otherwise he would not have made his recommendation today.

Mr. Mayo commented that it was difficult to abstract from the primary and secondary effects of the GM strike in assessing the economic situation. However, he thought the economy was not as strong currently as he had expected at the time of the previous meeting. That led him to view Mr. Axilrod's proposal regarding the purchase of coupon issues with some enthusiasm. He agreed that the System should not get deeply involved in such a program until after the Treasury financing was completed because of the risk that it would be misinterpreted. However, it seemed desirable to plan tentatively on buying a modest amount of coupon issues after mid-November. Although the purpose of the purchases might be misunderstood by some, the potential for a favorable psychological impact seemed to be considerable.

Mr. Mayo added that he would not want to bring long-term rates down at the cost of pressing short-term rates upward; he favored a balanced reduction in the entire interest rate structure. If necessary for that purpose, he would favor increasing the target rate for growth in money--perhaps to 6 per cent. That, combined with modest purchases of coupon issues, should set the stage for a reduction in long-term rates, which he hoped would develop in early 1971 after the present backlog of corporate and municipal financing had been digested by the market. He thought such a policy would also help sustain the modest expansion in housing under way. As he had indicated at a previous meeting, he feared that the present expansion in housing might prove to be only temporary.

Mr. Morris observed that he shared the staff's concern about the downward divergence of the economy from its projected path. If the weakness continued it would produce an unemployment rate higher than had been projected and higher than was socially acceptable. The staff projection that unemployment would be at a 5.9 per cent rate in the second quarter of 1971 was, he thought, predicated on the assumption of an unrealistically slow growth in the labor force. Through July the economy had seemed to be responding to policy about as had been expected, but it clearly had weakened in August and September. That fact should be reflected in the Committee's decisions on policy.

Accompanying the sluggishness in the economy, Mr. Morris continued, had been a sluggish response in interest rates--particularly in the key mortgage and long-term municipal rates. Currently, the trend of long-term municipal rates was upward rather than downward, primarily because the liquidity position of banks had not yet improved enough for them to buy such securities. Instead, they were concentrating their purchases in the shorter-term area--and in the process producing the steepest upward-sloping yield curve in history. That situation could lead to severe congestion in the municipal bond market and to a slowdown of new issues.

Mr. Morris said there was a danger that in assessing the outlook now, during a major auto strike, the Committee would be repeating the forecasting errors of 1959-60. Weakness in economy at that time had been attributed to a major steel strike in the fall of 1959, and the more fundamental weakness of underlying forces had gone unrecognized. Following settlement of the strike there had been a brief upturn in activity, but very soon thereafter the economy had slid into a recession.

In his judgment, Mr. Morris continued, the behavior of the economy in August and September created a _prima facie_ case that monetary policy had not been sufficiently expansionary. Such reasoning had led the board of directors of the Boston Reserve Bank earlier this month to submit a recommendation that the discount rate be reduced by 1/4 point to 5-3/4 per cent. Indeed, the businessmen on the board originally were unanimously in favor of a 1/2 point reduction. They argued that the volume of orders their firms were receiving was not consistent with staff forecasts of an upturn in the economy, and they also took note of the stickiness of interest rates. In their judgment a discount rate cut of 1/2 point would represent a modest and appropriate move toward a more expansionary policy. He had persuaded them that such a change would not be compatible with the outstanding proposal for redesign of the discount mechanism, and the directors finally had agreed on a 1/4 point cut.

Mr. Morris said he recognized that both the elections and the forthcoming Treasury financings represented constraints on discount rate action now. However, he hoped the System would give consideration to a modest use of that policy tool. In the meantime, he would urge a move to a more expansionary open market policy. Specifically, he favored increasing the target rate for money growth from 5 to 6 per cent as a short-run policy measure. While excessive for the longer run, a 6 per cent growth rate would be desirable for the period until it became clear that an upturn in activity was under way.

Mr. Morris added that he did not have much faith in the proposal for sustained purchases of coupon issues. He was quite familiar with the so-called "operation twist" of the early 1960's, since he had been a member of the Treasury staff at the time and had worked closely with Mr. Stone, then Manager of the System Open Market Account. Looking back on that operation, and taking account of the churning it had created in the money market, he would say that its value had been dubious at best. In his judgment Mr. Axilrod's proposal would not do much harm, but it was not likely to do much good either. In any case, it was no substitute for a more expansionary monetary policy.

Mr. Francis commented that the economy had been making a smooth transition away from inflation and inflationary expectations and so far the costs involved had been reasonable. In his judgment the Committee's policy decisions since 1969 had generally been good, and the results--in terms of total spending--had worked out quite well. Any inflation with so much momentum built into it inevitably was slow in coming under control, but he thought that monetary policy was achieving a considerable degree of success. Accordingly, he would not be inclined to veer from the present course on the basis of what appeared to him at the moment to be fragmentary data. He strongly endorsed Mr. Morris' views on the proposal to buy coupon issues.

Mr. Kimbrel remarked that, as best he was able to evaluate the comments of the Atlanta Bank's directors--particularly those who were businessmen or public representatives--the only difference between their views regarding inflation and those that Chairman Burns had observed at the Business Council meeting was with regard to timing. He was not sure that the directors saw the danger of inflation as being 18 or 24 months away; he thought they saw the danger as much more imminent.

Mr. Kimbrel reported that some of the directors believed that the economy was in a period of recovery while others felt that conditions would worsen in the period ahead, particularly when they looked at the employment figures. More and more people were confident that housing was on the rise but that the situation was one of inflation "full speed ahead". Some observers in the District expected an increase in capital spending by States and municipalities. Many were worried about the fiscal posture of the Federal Government.

Regardless of their individual views about the economy, Mr. Kimbrel continued, most of the directors seemed to be worried about the risk of the System's overreacting to the current sluggishness in activity. They were fearful that the System might lose its determination to fight inflation, and they hoped it would avoid raising inflationary expectations, particularly with wage settlements taking the turn they were.

Under those conditions, Mr. Kimbrel said, keeping to the target the Committee had established in the past seemed desirable. He would not favor a 6 per cent growth rate in the money supply. His reaction to the proposal that the System provide reserves through purchases of long-term coupon issues was that it might be worth a try.

Mr. Hickman said he agreed that data for August and September reflected weakness in the economy. Such indications were, of course, fallible, but there was enough evidence that activity was picking up more slowly than had been expected to make him uneasy. He was skeptical about the preliminary GNP estimates for the third quarter, but he did note their indication that the weakness in consumer spending was being offset in part by a pickup in housing and State and local government spending.

As to the proposal for purchases of coupon issues, Mr. Hickman continued, he would not necessarily want to wait until the next meeting to begin some limited probing; he would favor making some purchases in the coming period if the opportunity arose and the Treasury financing did not present a problem. At the same time, he would not expect such operations to accomplish much. It seemed clear from the record that the way to reduce the whole structure of interest rates was to increase the rate of growth of bank credit. In his judgment, domestic conditions at present argued for growth in money and bank credit at rates a little above those of 5 and 9 per cent, respectively, discussed in the blue book. He was concerned, however, about the increased spread that had opened up between domestic and foreign interest rates as domestic rates declined. For that reason he would favor holding to the blue book targets, at least until the outlook for interest rates abroad became clearer.

Mr. Robertson said he thought the discussion around the table today was entirely too pessimistic. In his opinion real progress was being made toward the control of inflation, which remained the number one problem. Some current economic indicators, notably the unemployment rate, were weaker than one might like, and it was important to avoid any action that would weaken the economy further. At the same time, the main task of the Committee at present was to avoid rekindling inflationary psychology.

Mr. Robertson observed that he was opposed to Mr. Axilrod's suggestion for buying coupon issues. Once it launched such a program, the System would have to persist in it if it were to attain and then maintain the desired level of interest rates. In effect, the Committee would be changing its targets from monetary aggregates to interest rates. While the previous "operation twist" had done little harm, a new operation could raise questions about the System's credibility.

Mr. Brimmer said that, since he would not be able to attend the next Committee meeting, he wanted to make his views on the purchase of coupon issues clear. When he had suggested earlier that the possibility be studied of purchasing agency issues as well as coupon issues he had not meant to endorse either type of operation. He would be inclined to give great weight to the comments just made by Mr. Robertson.

Mr. Brimmer said he agreed in general with Mr. Maisel on the desirability of scheduling a Committee discussion of the basic goals of monetary policy. At present, however, he thought the Committee and the Government as a whole were committed to the short-run goal of halting inflation. It had been clearly recognized that achieving that goal would involve a cost in terms of unemployment and excess capacity. He was not sure about the appropriate rates of unemployment and capacity utilization at this stage; the key point was that some margin of unused resources would have to be maintained for some time if inflation were to be stopped.

Mr. Maisel remarked that his interpretation of the Axilrod proposal was somewhat different from that implied by Mr. Robertson. The logic of the proposal, as he (Mr. Maisel) understood it, was that at a time when there was a liquidity demand in the market for short-term securities the System should make reserve injections by buying long-term issues--which might be in excess supply--rather than by competing for the available short-term issues. There would not be any specific targets for long-term interest rates.

In response to a request for comment, Mr. Axilrod agreed that he had not suggested the adoption of any specific interest rate target. However, he had associated the proposal with the desirability of reducing the level of long-term rates.

Mr. Mitchell referred to earlier comments by Mr. Morris advocating some step-up in the rate of growth of money, and remarked that the problems of bias in the statistics for money at present were such that no one could say what the current growth rate actually was. He thought the Committee should not rely on a yardstick with so many vagaries in formulating its goals. At the same time, he was inclined to share Mr. Morris' view that weakness in the economy might become evident when the strike and the post-strike catch-up were over. Accordingly, he thought the Committee should be concerned about the magnitude of the reduction in long-term interest rates that could be achieved during the next three or four months. The draft directive did not explicitly set forth that goal, but he had no objection to the proposed language as long as the Committee was agreed upon the goal and was not tying its policy mainly to the unreliable money supply figures.

With respect to Mr. Robertson's comments on the proposal to buy long-term issues, Mr. Mitchell recalled that the earlier "operation twist" had had dual objectives--to reduce long-term rates while holding up short-term rates. The thrust of the present proposal, as he understood it, was simply to help reduce long-term rates. He hoped the Committee would decide that operations in the long-term area should be undertaken. He would be surprised and disappointed if those operations did not have both market and psychological effects.

Mr. Clay observed that the recent economic information was rather mixed, but on balance it suggested a sluggish economy with slowly rising activity rather than a quick rebound. The most dramatic news had been the increase in unemployment. At the same time, there had been some further evidence of moderate improvement in the price situation. On the whole, however, the economic picture came within the bounds of the general approach to monetary policy that the System had endeavored to pursue this year.

Despite the increase in unemployment and the possibility of some further rise in that area, Mr. Clay said,he did not believe the situation called for a turn to a more stimulative policy. That view was particularly underscored when recognition was given to the lagging impact of monetary policy actions; to adopt a more stimulative policy now would be to incur the risk that its effects would appear at the same time as those of large wage settlements, resulting in over-stimulation. In that connection, he noted that little or nothing had been said about lags in the discussion so far today. It was also important to point out that the Federal fiscal outlook was not encouraging, and that too much stimulus was likely to result in coming months from spending programs in that sector.

A continuation of the current monetary policy appeared to Mr. Clay to be in order. The annual growth rates, indicated in the blue book, of 5 per cent for money and 9 per cent for bank credit for the fourth quarter, were acceptable; and some easing of credit conditions was also acceptable. While the staff projected that an easing of credit conditions would be consistent with the specified growth rates in those monetary aggregates, there remained the possibility of those two objectives proving to be incompatible. Much as credit easing might be desired, that should be accomplished only providing it emerged from the specified growth rates in money and bank credit. In other words, it would not seem wise to seek still faster growth rates in those aggregates to assure the easing in credit conditions. He favored continuing about the policy the Committee had been pursuing.

Chairman Burns said he would like to comment briefly on the subjects of profits and interest rates. In assessing the economic situation it was important, he thought, to recognize that the rate of corporate profits--that is, corporate profit margins--was now at its lowest level since World War II. Businessmen had been slow to recognize the erosion in profit rates, which had begun in the fall of 1965, but they were fully aware of it now and were, perhaps, in danger of overreacting. In any event, the cost-cutting under way was widespread and intensive. For the first time in the postwar period, people with jobs normally considered to be stable--such as clerical, supervisory, and scientific personnel--were discovering that their jobs were not necessarily stable after all; the cutback so far in the number of so-called "nonproduction" workers during the current mini-recession was very much larger than in any previous full-fledged recession of the post-war period. In manufacturing a curious situation had developed recently in which employment of production workers appears to have stabilized while that of nonproduction workers has continued to fall. The employment cutbacks would have some salutary economic effects--they were associated with the improvements in productivity that in turn provided the main basis for the expectation that the rate of price advance would slow over the next year or two. But the employment picture would remain cloudy--if not gloomy--for some time to come.

The Chairman went on to say that interest rates currently were very high by any historical standard. He personally was quite concerned about the present volume of interest charges relative to the gross income of businesses. Interest rates clearly were out of line with rates of profit--a situation that did not augur well for business capital investment. Much of the investment that was carried out would be aimed at further cost-cutting or at avoiding cost increases associated with current exorbitant increases in wage rates; but on the whole the outlook for the capital goods industries was not good. It should also be remembered that the projections of recovery in over-all economic activity depended heavily on strength in residential construction activity and in State and local government spending, both of which were quite sensitive to the level of interest rates. For all those reasons he hoped that interest rates would move down.

Chairman Burns then remarked that while he had no philosophical objections to Mr. Axilrod's proposal regarding System purchases of coupon issues, he shared some of the skepticism that had been expressed by others regarding the probable effectiveness of such operations. In particular, he suspected that to have a significant effect the purchases would have to be on an enormous scale. He was not sure of that judgment, however, and planned to seek the advice of specialists on the staffs of the Board and the New York Bank, and possibly others as well.

Chairman Burns added that he would like to say a word about the discount rate, an issue raised earlier by Mr. Morris. That rate had for some years been well below market interest rates, but it had been brought into closer alignment by the recent declines in market rates. In his judgment, a cut in the discount rate was not immediately desirable, but he welcomed the Boston Bank's action in initiating discussion of such a move. He thought the Committee members should all be discussing the subject very quietly among themselves and that the time might be close at hand when the Board would want to consider a small downward adjustment--perhaps of one-quarter of a percentage point as recommended by the Boston Bank.

The Chairman said that view reflected his belief that, as a general rule, the discount rate should not be used as an aggressive tool of monetary policy, leading market rates. It should, however, be kept in closer alignment with market rates, thereby making it a more meaningful control device than it had been recently. Such a policy would require smaller and more frequent changes in the rate, a development which he would welcome and which should help to reduce troublesome announcement effects.

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

> It seems to me that the present combination of circumstances argues strongly for holding to a no-change policy. By this I mean no significant change in terms of money market conditions unless the aggregates seem to be veering sharply away from their present satisfactory growth track. For one thing, the imminent Treasury announcement suggests the need for an even keel over the next few weeks. But beyond that, there are strong economic arguments both against any tightening and against any easing. The business situation has developed rather more sluggishly in the last month or so than had been expected, with only part of this development attributable to the General Motors strike. On the other hand, despite further evidence of some progress on the price front, wage pressures remain intense, and I can see a real danger of rekindling inflationary expectations if policy were to become too accommodating, especially with a large Treasury deficit to be financed in the current fiscal year. On the international front I am impressed by the growing unease abroad on the subject of the American economic and financial position, and once again warning signals are beginning to flash with respect to the dollar's international position.

In the light of all this it seems to me that the record of monetary policy so far this year has been fairly satisfactory. A near financial panic has been weathered, at least for the time being; the liquidity position of banks has been substantially improved; and both money and bank credit have grown at an appropriate pace. The magnitudes of the fourth-quarter growth rates now projected also seem about right, and there is reason to look for growth of this general magnitude without a further easing of money market conditions.

As far as the directive is concerned, I find that I am in agreement with the suggested blue book growth rates for money and the credit proxy for the fourth quarter and would not differ greatly from the specifications of money market conditions that the staff expects to be associated with these growth rates. I would not, however, want to specify a range limit as low as zero for net borrowed reserves. While the specifications for the aggregates and money market conditions appear reasonable, I would drop the clause about promoting "some easing of conditions in credit markets." I would do this partly because of the progress made since our August meeting in this direction. Moreover, even keel considerations and the general advisability of not pushing monetary policy too far and too fast towards ease require a period of no change, and I do not believe that the draft directive can be regarded as a "no-change" directive. Even keel will, of course, require rather close attention to money market conditions. Within that constraint I would be content to stay with a 5 per cent annual rate of growth for money. And a 9 per cent growth rate for the credit proxy also appears about right. I would observe closely the impact of this no-change policy on credit markets and would find it acceptable if maintaining the desired aggregate growth rates resulted in some further easing of credit market conditions, as the blue book suggests is likely. But this should be the natural result of demand factors stemming from the state of the economy rather than the result of a deliberate directive to the Manager to bring it about. Should the Committee decide to retain dual targets of credit market conditions and the aggregates, I would think it highly desirable to establish a sense of priority between the two for the Manager's guidance.

Bank credit, in my opinion, should be accorded a more important but perhaps not coequal position alongside money supply as a policy target. I would therefore amend the first sentence of the second paragraph of the directive to read: "To implement this policy, the Committee seeks to promote moderate growth in money and bank credit over the months ahead." The second sentence would be unchanged.

This morning there has been some discussion of a possible change in the discount rate. In view of the basic conditions that I have already discussed, I do not believe that a deliberate signal of further ease should be given at this time. This view is reinforced by even keel considerations and by the desirability of avoiding a discount rate change either immediately before, or immediately after, Election Day. Neither of these latter considerations would be decisive if a really strong economic case could be made for an immediate rate reduction, but I do not think that such a case exists. In addition, I should note that, from a market standpoint, there is no real reason for a change at this time. We were loathe to raise the rate when it was way out of line with the market for fear of giving an unwanted signal of further tightening. Today, the rate is roughly in line with the market, and even if market rates were to decline moderately, the spread would be much too small to raise any challenging questions such as we faced when it amounted to two or three percentage points. Over a period of time I would certainly think that we would wish to make the discount rate a more flexible instrument than it has been for the past three or four years. But this is not a problem that needs to be solved today, and I am glad that there is already in train a study on the concept and feasibility of smaller and more frequent discount rate changes by the Subcommittee on Discounts and Credits of the Conference of Presidents.

In response to a question from the Chairman, Mr. Hayes said he was not sure when the discount rate study to which he had referred would be completed, but it was not likely to be before the next meeting of the Committee.

Mr. Morris indicated that, for the reasons he had outlined earlier, he thought there was a need for a more expansionary monetary policy. He continued to be dissatisfied with the form of the directive but he could accept the draft proposed by the staff if the target path for money in the fourth quarter was increased to 6 per cent. He sympathized to some extent with Mr. Mitchell's concern over the unreliability of the data, but it seemed to him that Mr. Mitchell was exaggerating the resulting problem. If the pace of economic activity was inadequate the Committee could reasonably instruct the Manager to step up the rate of growth of money, however measured.

Mr. Coldwell said he did not believe the economy was experiencing a cumulative downturn in activity, but he thought it was still in a period of transition. He hoped the Committee would not overreact to the currently disappointing economic statistics; the lagged effects of further easing could come back to haunt the Committee later. Some reaction would, of course, be required if the indications of weakness persisted, but at present he would maintain the status quo in policy, especially in light of the Treasury financings. He would hold to a 5 per cent target for money growth and would instruct the Manager to pay somewhat more attention to the bank credit proxy and to total reserves. As to the wording of the directive, like Mr. Hayes he was troubled by the clause calling for "some easing of conditions in credit markets." He would prefer to amend the language to read in part "...the Committee seeks to promote stability in credit markets and moderate growth in money...."

Mr. Coldwell added that he did not think it would be desirable for the Committee to undertake a program of buying Treasury coupon issues. He thought that such purchases would be unwise in the present context and would probably prove unfruitful in the longer run unless they were on a massive scale. He also believed that a change in the discount rate was not needed immediately, but that the time for such a change was approaching.

Mr. Swan agreed that the Committee should remain on its current policy course for the present despite the lack of favorable economic statistics in the past month or so. He would accept the draft directive proposed by the staff as continuing the policy stance adopted at the last meeting. He regarded the money market conditions proposed in the blue book as appropriate and, similarly, he would accept a target rate of growth of 5 per cent, or a little more, for the money supply. He would, however, want to increase somewhat the emphasis given to bank credit. Like Mr. Hayes, he was not wholly happy with the clause calling for "some easing of conditions in credit markets," but he did not have alternative language to suggest.

Turning to the proposal for purchases of Treasury coupon issues, Mr. Swan noted that opportunities for such purchases would be quite limited during the period of even keel, so that the question could be deferred until the next meeting. In any event, he would not be surprised to see some decline in long-term interest rates even in the absence of System intervention; indeed, mortgage rates had already begun to recede in the West. Moreover, the Desk already did buy some coupon issues from time to time, and that practice could be continued while the Committee was deciding whether to undertake the type of program recommended by Mr. Axilrod.

Mr. Swan added that he thought this was not the time for a reduction in the discount rate, particularly in view of the Treasury financings. However, the appropriate time might be only a few weeks off. In any move which would relate the discount rate more closely to market rates, he would not rule out changes as small as 1/8 of a percentage point.

Mr. Galusha remarked that the present would be a propitious time to inaugurate the new discount mechanism, as a preliminary to initiating later in the year the kinds of small changes in the discount rate that should have minimal announcement effects.

With respect to open market policy, Mr. Galusha said it now appeared that a more marked shift toward ease than had seemed necessary earlier would be required to achieve an appropriate pace of economic activity, allowing for lagged effects. He thought the Committee might have to accept a higher rate of growth in the aggregates over the near term than it would want to sustain over the longer run, and accordingly he favored giving serious consideration to a 6 per cent target rate for money growth as soon as the Treasury financings permitted.

Mr. Mayo said he agreed with Messrs. Galusha and Morris on the appropriateness of a 6 per cent target rate for money growth. Moreover, his concern about the lagged impact of monetary policy actions led him to the view that such a move should be taken promptly. With regard to the language of the directive, he would prefer adding the word "further" in the first sentence of the second paragraph, which would then read in part, "...the Committee seeks to promote some further easing of conditions in credit markets...." However, if the implication of some further easing could be read into the staff draft, as had been suggested, he would accept the directive as drafted on the understanding he had noted earlier with respect to the money supply target.

Mr. Clay said that, as he had indicated earlier, he found acceptable the target growth rates of 5 and 9 per cent for money and bank credit which were discussed in the blue book.

He could also accept some easing of conditions in credit markets to achieve those growth rates, if that turned out to be necessary as the staff believed, but he would not want to foster easier credit conditions through faster growth in the monetary aggregates.

Mr. Clay added that in his judgment the time had not yet arrived for a change in the discount rate, but if money market rates continued to decline the appropriate time might not be too far away. It was his hope that the discount rate would be kept at more meaningful levels in the future in relation to market rates, and specifically, that more frequent and smaller increases or decreases would be made as market conditions required. Such a policy would serve to play down the announcement effects of the discount rate changes.

Mr. Black said he shared the uncertainty others had expressed as he tried to determine just where the economy stood at the moment. His best guess was that the downturn had ended and that the economy was in a phase of slow recovery. But regardless of whether that assessment was correct or not, it was certainly clear that the economy was on a course that was well below its potential. That being the case, the key question the Committee faced today, in his view, was how rapidly it should try--through monetary policy--to force the economy up to its maximum growth path. He believed rather strongly that that was something which should not be rushed in view of the persistent threat of a resurgence of inflationary expectations. Following a slow deliberate policy course would obviously be painful, but he thought the Committee could not avoid that cost if it was to uphold its responsibilities for the price level. Accordingly, he favored continuing the efforts to achieve a 5 per cent rate of growth in the money stock, as outlined in the blue book. He would not change the discount rate now, but if short-term rates dropped below the discount rate he would reopen the issue.

Mr. Mitchell noted that the money supply statistics for the third quarter had been subject to relatively large revisions in recent weeks. In the past week alone the third-quarter growth rate had been revised up from 4.0 per cent to 5.0 per cent--a rate which happened to coincide with the Committee's objectives. The revision might very well have gone the other way, however, and he concluded that the Manager could not reasonably be given a specific target rate in money growth unless it was understood that there might be large deviations from the target.

Turning to the directive, Mr. Mitchell said he found the staff draft acceptable. He would not delete the reference to "some easing of conditions in credit markets" as suggested by Mr. Hayes, nor would he be concerned if the bank credit proxy were to grow at a rate significantly in excess of 9 per cent over the fourth quarter. In fact, he thought such growth should be encouraged since an effort to restrict bank credit expansion would have undesirable consequences in forcing banks to curtail their construction loans and their purchases of municipal securities. He added that some easing of money market conditions, including a shift to net free reserves, would not appear inconsistent with the sort of policy he had in mind.

Mr. Maisel said he thought the Board should consider adopting the proposed new discount mechanism in the near future and might postpone consideration of a discount rate change until after the new mechanism was announced. He would also defer consideration of Mr. Axilrod's proposal for purchases of coupon issues until the next meeting of the Committee.

Turning to the Committee's current policy stance, Mr. Maisel said he thought the Committee should aim for a target rate of growth in money over the second half of 1970 that was equal to the growth rate achieved in the first half, namely a 5-1/2 per cent annual rate after correction for known biases in the data. Since a somewhat lower rate of growth was projected on the basis of the money market conditions specified in the blue book, he would instruct the Manager to gear his operations to achieve somewhat easier conditions, including a Federal funds rate mostly in a 5-3/4 to 6 per cent range. If growth in money subsequently appeared to be exceeding 5-1/2 per cent, the Federal funds rate and related money market conditions should be tightened.

Mr. Brimmer said he thought a continuation of the current monetary policy would be appropriate under present circumstances. In particular, he would be opposed to raising the target rate of money growth to 6 per cent. As at the previous meeting, he favored instructing the Manager to give a little more weight to bank credit than had been the case earlier in the summer. He had no changes to suggest in the second paragraph of the draft directive. With respect to the statement about the balance of payments in the first paragraph, the Committee might want to consider expanding the reference to the reduction of Euro-dollar liabilities by U.S. banks to include a further statement about the announced intention of several banks to continue reducing such liabilities.

Mr. Holland suggested that that development might appropriately be reported in the policy record prepared for this meeting rather than in the directive itself, and Mr. Brimmer agreed.

Mr. Sherrill observed that the relatively weak economic indicators of recent weeks were in line with what he had expected earlier after talking with a number of businessmen. He anticipated continued weakness in those indicators.

Mr. Sherrill noted that recent projections of a recovery in economic activity relied heavily on strength in residential construction, consumer spending, and State and local government outlays. Residential construction was providing some stimulus to the economy, but he feared that rising construction costs would tend to cut down effective demand for housing. Consumer spending was failing to display the expected strength, and it was likely to remain relatively weak in light of the reduced growth in personal income and the psychological impact of rising unemployment and prices. Expansion in State and local government expenditures might well represent the best hope for stimulating the economy, but strength in that sector would depend upon the achievement of lower interest rates. In that connection he agreed with Mr. Axilrod that lower long-term rates would be desirable, and he thought Mr. Axilrod's proposal for operations in coupon issues might have some merit. The effectiveness of such operations would depend in large measure on their timing: If bond yields were poised to decline, System operations would accelerate the process; otherwise, such operations might at best have only a marginal impact on rates.

As far as general policy was concerned, Mr. Sherrill believed that the Committee should now raise its target rate for money growth. Given the lagged effects of monetary policy it was important to move as promptly as possible to a more stimulative posture in order to establish a sound basis for a recovery in economic activity next year. Otherwise, the economy was likely to remain sluggish, and it could weaken considerably. As he understood the inflationary fears of businessmen, they were related mainly to cost-push pressures--not to demand pressures, which would be indicative of strength in the economy. Moreover, if numerous workers succeeded in obtaining higher wages only after strikes, the additional compensation would initially be used to repay debts rather than to expand consumption.

Mr. Sherrill added that a target rate of 6 per cent for growth of money in the fourth quarter seemed about right to him, but he would not want such a goal to be rigidly interpreted in view of the problems Mr. Mitchell had noted with respect to the money supply statistics. Perhaps it would be better to say simply that he favored a further step in the direction of easier money market conditions to foster more rapid growth in money. That might include moving the Federal funds rate down into a 5-3/4 to 6 per cent range. He realized that because of even keel constraints the Desk would have only limited leeway to implement such a change in the interval until the next meeting, but it should do what it could. He would not be concerned if bank credit were to expand significantly more than the 9 per cent annual rate projected by the staff for the fourth quarter, since much of the additional credit would probably be directed to sectors in need of stimulus, such as construction and State and local governments.

Mr. Hickman expressed the view that the targets for money and bank credit proposed in the blue book were about right. If moderate deviations from the target growth paths were to occur, he would prefer that they be on the high side, given the weakness in the latest economic indicators. He would be inclined to give slightly more weight to bank credit than some members of the Committee.

With regard to the draft directive, Mr. Hickman said he was puzzled by the language in the second paragraph indicating that the Committee wanted "to promote some easing of conditions in credit markets." If the intention was to refer to long-term rates, he would be happy to see them decline but he doubted that the Committee itself could do much to foster a decline. If the reference intended was to money market conditions, he thought current money market conditions were about right--indeed, he would favor instructing the Manager to aim for the mid-points of the ranges described in the blue book. Thus, he would prefer language along the lines suggested by Mr. Coldwell, calling for the maintenance of current conditions in credit markets, or the deletion of the reference to credit markets altogether.

Mr. Hickman added that he did not think the time had arrived for a change in the discount rate. The directors of the Cleveland Bank had been discussing the question, and he thought they might be in favor of a small reduction in the rate some time soon if market interest rates continued to decline.

Mr. Eastburn remarked that he wanted to second Mr. Black's comments regarding the rate of growth in economic activity, which was slower than forecast and below the economy's potential. He was afraid, however, that attainment of the GNP growth rate needed to move the economy up to its potential would cause a resurgence of inflationary pressures. In that connection he noted that the directors of the Philadelphia Bank felt that inflation was an immediate problem, and not just one to be faced 18 months from now. His policy preference would be to hold to a 5 per cent target for money growth.

Mr. Eastburn said he agreed that the present was not the appropriate time for a reduction in the discount rate. When that time did arrive, he hoped it would be made clear that the discount rate instrument was being used in a different way from that of the past.

Mr. Kimbrel noted that Treasury financing operations during the forthcoming period would not permit the Committee to make any major policy changes. Even if action were not limited by Treasury financings, he did not believe that a change in policy would be appropriate. If it proved impossible to achieve the exact rates of expansion in money and bank credit described in the blue book without a rapid and massive decline in money market rates, he would be satisfied with somewhat slower growth in money--say, in the neighborhood of 4 per cent over the quarter. With that understanding, if he had a vote he would be prepared to accept the directive as drafted.

On the subject of the discount rate, Mr. Kimbrel continued, it was his hope that changes would be made more frequently and in more modest amounts over a period of time. Such an approach hopefully would contribute to an alleviation of some of the unjustified announcement impact which discount rate changes currently conveyed. While the System might be approaching a time for serious discussion of some modest reduction in the discount rate, he did not think the time was yet appropriate.

Mr. Francis commented that he did not share the apparent uneasiness of some members of the Committee regarding the current stance of monetary policy. Despite the "vagaries" of the money supply figures, the economy was just about on the path projected by the St. Louis Bank staff, though somewhat below the Board staff's projections. The St. Louis Bank estimated that a 5 per cent rate of growth in money was likely to result in a 6.5 per cent rate of growth in spending a year from now. Furthermore, the estimates indicated that, while real production would be rising at close to its estimated long-run potential rate, inflation would nevertheless be receding. He would therefore prefer a 5 per cent target rate of growth for money in the near future. If monetary expansion were at a rate greater than 5 per cent, he thought the Committee would run an undesirable risk of fostering a growth of total spending which would maintain and reinforce inflationary pressures and expectations.

Turning to the directive, Mr. Francis said he would prefer to omit the reference in the second paragraph to "some easing of conditions in credit markets." He could accept that language, however, if it was felt to be consistent with a 5 per cent rate of growth in money.

Mr. Francis also said he agreed with Chairman Burns' comments regarding the discount rate.

Mr. Robertson indicated that if the draft directive meant a no-change policy, as he assumed it did, he was prepared to vote for it.

Chairman Burns said today's go-around had been helpful; it was only natural that some diversity of views should emerge at a time like the present. His own policy views could be summed up in a few sentences. He was temperamentally opposed to frequent shifts in policy that were not clearly necessary, and while the economic situation had deteriorated, he thought the System's present policy stance remained appropriate for the time being. Thus, he was not prepared as yet to advocate a 6 per cent target rate for growth in money. However, he certainly did look forward to some reduction in interest rates, although not necessarily in the coming even keel period. Unless there was a reduction before too long in the general structure of interest rates, he was afraid the U.S. economy would be in serious trouble.

As for the directive, the Chairman continued, he would accept the proposed second paragraph as representing essentially no change in policy from the previous meeting. However, he would like to suggest a language change in the opening sentence of the first paragraph shown in the staff's draft. He would prefer to say that "...real output of goods and services increased...." rather than "...real economic activity increased...." The latter was potentially misleading because "activity" could be taken to include such measures as employment and capacity utilization.

There was general agreement with the Chairman's suggestion.

The Chairman then proposed that the Committee vote on the staff's draft directive with the change in the first sentence just discussed.

Mr. Hayes said he favored no change in policy. He regretted that he found it necessary to vote against the proposed directive, but he could not accept a directive stating that "the Committee seeks to promote some easing of conditions in credit markets" as calling for no change. He would define no change as involving stable growth rates in the aggregates and maintenance of money market conditions essentially as they were now. He was disturbed in particular by the implication of the proposed language that a persistent push toward lower interest rates was intended.

Messrs. Hickman and Swan also expressed reservations about the clause to which Mr. Hayes had referred, but indicated that they planned to vote affirmatively nevertheless. Mr. Hickman said his concern was mainly that the meaning of the clause seemed to him to be unclear. Mr. Swan remarked that he took some comfort from the language indicating that the easing of credit conditions was to be sought "over the months ahead" rather than simply in the interval until the next meeting.

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

> The information reviewed at this meeting suggests that real output of goods and services increased slightly further in the third quarter but that employment declined and unemployment continued to rise; activity in the current quarter is being adversely affected by a major strike in the automobile industry. Wage rates generally are continuing to rise at a rapid pace, but improvements in productivity appear to be slowing the increase in costs, and some major price measures are rising less rapidly than before. Most interest rates have declined since mid-September, although yields on corporate and municipal bonds have been sustained by the continuing heavy demands for funds in capital markets. The money supply rose slightly on average in September and increased moderately over the third quarter as a whole. Bank credit expanded further in September but at a rate considerably less than the fast

pace of the two preceding months. Banks continued to issue large-denomination CD's at a relatively rapid rate and experienced heavy inflows of consumer-type time and savings funds, while making substantial further reductions in their use of nondeposit sources of funds. The balance of payments deficit on the liquidity basis diminished in the third quarter from the very large second-quarter rate, but the deficit on the official settlements basis remained high as banks repaid Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives, taking account of the forthcoming Treasury financings.

Mr. Holland noted that he had sent to the Committee a memorandum, dated October 16, 1970, and entitled "Annual Reports of Manager and Special Manager."[1/] The memorandum indicated that much of the traditional content of those reports was now made public in other forms, and it proposed that the reports for this year be accepted with substantial condensation. It also indicated that both Managers and the Committee's Economist concurred in that suggestion.

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

The proposal contained in Mr. Holland's memorandum was noted without objection.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, November 17, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

October 19, 1970

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 20, 1970

The information reviewed at this meeting suggests that real economic activity increased slightly further in the third quarter but that employment declined and unemployment continued to rise; activity in the current quarter is being adversely affected by a major strike in the automobile industry. Wage rates generally are continuing to rise at a rapid pace, but improvements in productivity appear to be slowing the increase in costs, and some major price measures are rising less rapidly than before. Most interest rates have declined since mid-September, although yields on corporate and municipal bonds have been sustained by the continuing heavy demands for funds in capital markets. The money supply rose slightly on average in September and increased moderately over the third quarter as a whole. Bank credit expanded further in September but at a rate considerably less than the fast pace of the two preceding months. Banks continued to issue large-denomination CD's at a relatively rapid rate and experienced heavy inflows of consumer-type time and savings funds, while making substantial further reductions in their use of nondeposit sources of funds. The balance of payments deficit on the liquidity basis diminished in the third quarter from the very large second-quarter rate, but the deficit on the official settlements basis remained high as banks repaid Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

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