MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday and Tuesday, November 20 and 21, 1972. The meeting began at 2:30 p.m. on Monday.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Eastburn
Mr. MacLaury
Mr. Mitchell
Mr. Robertson
Mr. Sheehan
Mr. Winn
Mr. Francis, Alternate for Mr. Coldwell

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

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

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

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Messrs. Coyne and O'Brien, Special Assistants to the Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, Adviser, Division of International Finance, Board of Governors
Mr. Zeisel, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Grimwood, Assistant Director, Office of Executive Director, Board of Governors
Mr. Ring, Assistant Director, Division of Federal Reserve Bank Operations, Board of Governors
Miss Stockwell and Mr. Taylor, Assistant Advisers, Division of Research and Statistics, Board of Governors
Mrs. Junz, Assistant Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Messrs. Peret and Wetzel, Senior Economists, Division of Research and Statistics, Board of Governors
Messrs. Enzler and Wyss, Economists, Division of Research and Statistics, Board of Governors
Miss Morrissee and Mr. Promisel, Economists, Division of International Finance, Board of Governors
Mrs. Sherman, Secretary, Office of the Secretary, Board of Governors

Mr. Plant, First Vice President, Federal Reserve Bank of Dallas
Messrs. Eisenmenger, Parthemos, Taylor, Scheld, Andersen, and Craven, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, St. Louis, and San Francisco, respectively
Mr. Doll, Vice President, Federal Reserve Bank of Kansas City
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York

Chairman Burns noted that the Committee had agreed to devote its session this afternoon to two matters: a staff presentation on the economic outlook, and a discussion of Committee procedures with respect to monetary policy targets and instructions to the Manager. Before turning to those matters he might note that, as the Reserve Bank Presidents had already been advised, the Board had decided earlier today to publish a proposed revision of Regulation A which was designed primarily to assist smaller banks in meeting the seasonal borrowing needs of their communities. An announcement concerning the proposed revision would be released to the press tomorrow afternoon.

In the same connection, the Chairman continued, he might mention that the Board planned to consider on Wednesday a proposal to establish a staff committee to be charged with responsibility for reviewing Federal Reserve lending operations in all aspects and with promoting uniform discount window administration. The staff committee, working jointly with the Subcommittee on Discounts and Credits of the Conference of Presidents, would conduct necessary studies and would make recommendations to the Board. It would be helpful to the Board to have any thoughts the Reserve Bank Presidents might care to express on that proposal.

In response to a question by Mr. Heflin, Chairman Burns said the proposed committee would consist of members of the Board's staff under the chairmanship of Mr. Melnicoff, Deputy Executive Director.

In reply to questions by Messrs. Heflin and Hayes, Mr. Melnicoff said the staff committee would include representatives from each of the Board's Divisions having responsibilities related to System lending operations. In general, the group would provide a forum for discussions within the Board's staff of many of the same issues that were now discussed by the President's Conference Subcommittee on Discounts and Credits. One of the initial tasks of the group would be to make further studies of the short-term "basic borrowing privilege" that had been recommended by the System's task force on the discount mechanism. Its first concerns would be with the proposed seasonal borrowing privilege and with borrowing by nonmember depositary institutions in connection with Regulation J. In carrying out credit-discount studies, the committee would attempt to utilize staff resources of the Reserve Banks and of the Subcommittee on Discounts and Credits. As Chairman Burns had indicated, it would work jointly with the latter group; on particular questions, for example, the staff committee might make recommendations to the Board while the Subcommittee was performing a similar function for the Conference of Presidents. No change was contemplated in the present program of periodic meetings of the discount officers of the twelve Reserve Banks.

Mr. Robertson asked whether the proposal did not simply amount to formalizing an arrangement that had existed informally for the last few years, and Mr. Melnicoff responded affirmatively.[1/]

1/ Messrs. Grimwood and Ring left the meeting at this point.

Chairman Burns then called for the staff presentation on the economic outlook.

Mr. Partee began the presentation with the following introductory statement:

Today's presentation represents the staff's second major effort at projecting the shape and size of economic expansion in 1973. As background for this "second look," I would note that current indicators of activity are impressively strong and give every evidence of substantial upward momentum.

Following a brief lull in late spring and early summer, both industrial production and employment have been rising strongly in recent months. The upward course in retail sales in real terms is particularly impressive; the sharp rise in October reflects both strength in new car buying and substantial gains in other lines, stimulated in part by the recent boost in social security benefits. Manufacturers' new orders for durable goods have also continued strongly, though irregularly, upward--with orders for nondefense capital goods rising somewhat faster than the total.

Given the current environment, and the apparent associated strengthening in business and consumer confidence, we see no reason to alter significantly our earlier expectations for continued strength in the economy, though some tapering in growth still seems likely in the latter part of 1973. Nor, since this outcome seems highly desirable, have we modified our basic monetary assumption, which calls for continued moderate monetary expansion as indexed by a 6 per cent rate of growth in money narrowly defined.

But we have attempted to take into account altered assumptions regarding other aspects of governmental policy. First, our projection assumes some success in limiting Federal outlays in fiscal 1973 and beyond. Our $253 billion number for fiscal 1973 is midway between the $250 billion ceiling that came close to adoption and the $256 billion that otherwise would seem to be in train. The $3 billion curtailment postulated, in the absence of specific legislative authorization, would represent a substantial accomplishment, since nearly half of the fiscal year is behind us. Second, we are now assuming a continuation of controls in 1973 with something like the same degree of restraint as in the present program. For reasons that will be explained, cost-price pressures are likely to intensify in the year ahead; nevertheless, the assumed effect of the program is to hold both wage increases and business profits--the main components of our price projection--below what they otherwise would be.

Mr. Zeisel will discuss wage and price developments later on. Mr. Pizer will present updated views of the International Division on foreign trade and balance of payments prospects. And Mr. Gramley will discuss policy choices in the fiscal and monetary areas, along with the possible implications of our projection for interest rates and the financial markets. First, however, Mr. Wernick will present the details of our economic projection for the year ahead.

Mr. Wernick made the following comments:

Prospective developments in major sectors of the economy point to a strong and relatively well-balanced expansion continuing through 1973. For this quarter and the first quarter of next year, we are projecting increases of over $30 billion in GNP, reflecting a large advance in consumer expenditures, strong gains in business fixed investment, and stepped-up inventory accumulation. GNP gains then seem likely to moderate as 1973 progresses, as consumer spending slows after tax refunds have been completed, housing starts trend downward, and the rate of inventory investment levels off. Real GNP growth is expected to accelerate to about a 7.5 per cent annual rate this quarter, continue at a substantial though lesser rate in the first half of 1973, and then moderate to about a 4-1/2 per cent rate in the latter part of the year. If so, economic expansion in late 1973 would be proceeding at a rate about in line with our long-run potential.

Our fiscal policy assumptions, as already noted, imply a relatively taut rein on Federal spending. Nevertheless, there would still be a large bulge in fiscal stimulus in this and the next two quarters, when the NIA deficit is expected to exceed $30 billion.

The size of the deficit over this period is largely accounted for by special factors, such as the recent 20 per cent social security increase, retroactive revenue sharing payments, and the large personal tax refunds anticipated in the first half of next year.

The high rate of deficit projected because of these special factors hides a very substantial $10 billion increase in social insurance taxes beginning in January 1973, but in the second half of the year we are projecting a significant move toward fiscal restraint. Rapid growth in Federal revenues and limits on spending are expected to reduce the NIA deficit to an average of about $13 billion. Calculated on a high employment basis, a small fiscal surplus is in prospect by the end of 1973.

We translate expenditure restraint to mean a leveling off in Federal purchases during 1973; in 1972 there was a 9 per cent increase. Defense purchases, which dropped abruptly in the third quarter, are expected to remain relatively flat, while other purchases are likely to show little or no growth--despite higher Federal pay beginning in January.

In contrast, State and local purchases are projected to rise more rapidly in 1973--the result of additional funds provided by revenue sharing and the generally improved fiscal position of many State and local jurisdictions.

Even though Federal purchases show little growth, the Federal budget will be contributing to expanding private demands, especially consumer spending, through the first half of 1973. Strong upward momentum is now evident in retail sales, reflecting both increasing consumer optimism and large gains in income flows. In the current quarter disposable income is expected to increase by $27 billion, reflecting the large boost in social security benefits as well as a step-up in private wages and salaries due to increased hiring, widespread overtime work, and pay increases.

Further large gains in disposable income are in prospect for the first half of next year. The tax refunds will add substantially to disposable income, and jobs and earnings are expected to continue to advance rapidly. As before, our projection assumes that consumers will save about half of the tax refund and the saving rate will rise. We have, however, become somewhat uneasy about that assumption, since a special University of Michigan Research Center survey conducted in August shows widespread taxpayer unawareness that refund checks will be larger and more numerous next spring.

In the second half of next year, we believe that the growth in disposable income will slow markedly. This reflects mainly the loss of tax refunds as a special income supplement, but increases in employment are also projected to be less rapid. The rise in consumer spending is likely to moderate, but not as much as income, and the saving rate should decline to more normal levels.

The quite bullish outlook for consumer spending, if realized, seems likely to stimulate solid gains in business fixed investment. Capital outlays are projected to advance by about 12 per cent in 1973--close to the gain indicated for this year--and in line with recent private surveys of anticipated plant and equipment spending. The expected growth in real outlays significantly exceeds the average of past recoveries, for a number of reasons--including the continued influence of the investment tax credit, rising unit labor costs, relatively ample internal cash flows, and the continuing vigorous growth of demands. In addition, factory utilization rates are projected to increase further, which should begin to push up spending for plant construction from current low levels.

Last year, strength in capital spending came disproportionately from the non-manufacturing industries--especially the utilities. The focus is now expected to shift to manufacturing, as it usually does in an extended period of rapid economic expansion.

With consumer and business sales expected to continue to advance rapidly, we have again projected an appreciable rise in inventory investment into 1973. However, the projected increase in inventories is closely aligned with climbing sales, so that the over-all inventory-sales ratio would remain close to its currently low level.

With stocks low relative to sales, we believe that there is potential for a larger rise in inventory investment than we have projected. Indeed, in the past few months there has been evidence of substantial acceleration in inventory accumulation; GNP inventory investment for the third quarter has been revised upward by about $2 billion. But businessmen generally still seem to be taking a conservative view of their inventory requirements, so that we believe there would be strong resistance to any sustained rate of accumulation in excess of sales.

Another sector showing more recent strength than we had anticipated is residential construction. Nonetheless, it still seems probable that demand factors will begin to impinge on housing activity next year, particularly multi-family construction. In addition, subsidized housing starts appear likely to decline because of Federal budget considerations. We are projecting starts at 2.1 million for the year as a whole, but we anticipate a steady decline as the year progresses.

Mortgage credit conditions are not expected to be an important constraint on the 1973 housing outlook. Although short-term market interest rates are likely to be rising somewhat, inflows of savings to mortgage lending institutions are projected to remain sizable. If so, and with the demand for mortgage funds easing, the supply of funds should not be a major consideration.

The large demands for goods envisaged in our GNP projection for 1973 imply faster gains in industrial production than in real GNP, continuing the pattern that has recently emerged. Consequently, demands for labor in manufacturing and other industrial components of employment would also remain strong.

Mr. Zeisel made the following comments regarding employment, wages, and prices:

We expect further good gains in employment throughout next year--especially in the first half, accompanying rapid growth in output. In the cyclically volatile manufacturing sector, further employment recovery should be stimulated by rising production of consumer durable goods and business equipment and by increased inventory investment. We anticipate continued strong job growth outside of manufacturing as well. Large gains are expected to continue in trade and services, and growth in State and local employment should benefit from general revenue sharing.

Thus far, we have had an unusually small improvement in unemployment, with the over-all rate down only half a point from the cyclical trough 2 years ago. During 1971, gains in both output and employment were relatively small. In 1972, job growth accelerated considerably, but the rate of increase of the labor force also stepped up--reflecting in part a rise in participation rates as demand for workers strengthened, and in part the return of more than 300,000 young veterans to the civilian labor market in the past year.

With demand for workers strong, we expect labor force growth next year again to exceed the approximately 1-1/2 million that would result from basic trends in population and participation rates. But with the size of the armed forces stabilizing and with large cyclical increases in participation rates behind us, some slowing of civilian labor force growth is anticipated from this year's rate. Employment gains are also likely to be moderating as the year progresses, however, so that the unemployment rate, after falling to around 5 per cent by mid-year, is projected to decline very little more by year's end.

Continued ample supplies of labor, along with the direct and indirect effects of Pay Board standards, slowed the rise in average hourly earnings over the past year. While the last 2 months have seen a new upward surge, the implications of this are not yet clear; it may reflect a temporary bunching of wage increases, or merely seasonal adjustment problems. Taking a longer view, in the 9 months since January--following the post-freeze wage bulge--adjusted average hourly earnings have risen at a 5-1/2 per cent annual rate, about 1 percentage point less than in 1971 prior to the freeze. The moderation of wage increases in construction has been most dramatic, and probably reflects several factors--including some shift to less unionized construction activity and union concerns that they may be pricing themselves out of the market, as well as the effectiveness of the Construction Industry Stabilization Committee. In manufacturing the improvement has been modest, but the rate of rise in earnings, on the average, has been in line with Phase II goals. The less unionized sectors, such as services, appear to have been significantly affected by labor market slack as well as by the direct and indirect effects of controls; earnings increases in these sectors this year have averaged under 5 per cent.

As indicated earlier, we have assumed that the wage control program will continue to hold down the rise in hourly earnings in 1973, but upward pressures on wage rates nevertheless seem certain to mount. A much heavier schedule of major contract reopenings is in the offing, and substantial concern is likely to persist over current and prospective rises in consumer prices. Moreover, wages in the service-type sectors--some of which are largely uncontrolled--are likely to be pushed upward in the second half of 1973 by a mid-year increase in the minimum wage and by tighter labor market conditions.

It is true that unemployment of 5 per cent--the projected rate for the last half of next year--has not in the past generally been associated with labor market stringency. However, there is some indication that structural changes in the labor force over the past decade have tended to raise the over-all unemployment rate, largely as a result of a substantial increase in the proportion of younger workers, whose unemployment rates are historically much higher than average. With the labor force age-sex composition of a decade ago, the current unemployment rates for detailed age and sex groups would result in a standardized total unemployment rate about half a point lower than the reported actual total. Nevertheless, unemployment rates next year for key occupational groups such as skilled blue collar workers and professional and technical workers seem likely to remain higher than in late 1965 and 1966 when the labor market began to tighten appreciably.

On balance, we expect the growth in adjusted hourly earnings to average around 6 per cent next year, about half a percentage point above the rate so far this year. Compensation per manhour in the private nonfarm economy, which also includes fringe benefits and white collar earnings, is likely to rise even faster--at annual rates of nearly 8 per cent in the first half of the year and about 6-1/2 per cent in the second half. The bulk of the additional increase in the first half reflects the employer share of higher social security taxes effective January 1; later, the minimum wage increase at mid-year raises second-half compensation costs moderately, over-all.

The impact of rising compensation on unit labor costs was cut sharply in 1971, and even more this year, by strong gains in output per manhour. Productivity increases for the private nonfarm economy--4-1/2 per cent last year and an estimated 5-1/4 per cent this year--substantially exceed the long-term average and have already brought cumulative productivity growth back to its long-term trend line.

However, growth in productivity seems likely to moderate during 1973, particularly if gains in real output slow, as expected, later on in the year. With both larger increases in compensation and slackening productivity growth in prospect, the rise in unit labor costs is projected to average about 4 per cent in 1973, much higher than in 1972.

In our view, this prospect of larger cost increases creates major difficulties for holding the rate of price inflation down. Price changes over the past several years have conformed broadly to movements in unit labor costs--though the recent improvement in cost performance has not been fully matched in prices. For 1973, in an atmosphere of strong demands by both consumers and business, we would expect the resumption of greater increases in unit labor costs to be reflected in large part in price behavior, particularly since controls permit a pass-through within limits of allowable cost increases. The only significant offset to the upward movement may come with some easing in the rise of food prices late in 1973, when increased supplies of some meats are anticipated. Over-all, we are projecting a rate of rise in the GNP fixed-weight price index of about 3-1/2 per cent in the first half of next year and close to 4 per cent in the second half, compared with about 3 per cent in the current period.

Mr. Pizer made the following comments on the balance of payments:

We want to focus attention first on the recent performance and outlook for the current account in the balance of payments.

We believe we have now passed through the worst period for the trade balance, and in the year ahead we should see progressively smaller deficits. While the trade deficit in the fourth quarter of next year is still projected to be uncomfortably large--a $3 billion annual rate--that would be a marked gain over the peak rate of nearly $8 billion recorded in the second quarter of this year.

Some of the year-over-year gain in exports will be in agricultural products, though these are expected to level out soon at about their present high rate. The major gain is projected for other goods, mainly machinery and industrial materials, that respond more directly to the pickup anticipated in economic activity abroad and to our improved competitive position.

Economic activity in major countries abroad is expected to show growing strength next year. Such rapid growth of activity abroad should support a strong increase in U.S. exports, as it has in the past. The Smithsonian devaluation of the dollar should also have a strong effect on exports next year, since U. S. goods should move in greater volume at prices that are somewhat higher in terms of dollars, but lower in terms of foreign currencies. We are assuming that the actions now being taken in Europe to slow inflation will not abort the projected gains in real output.

Meanwhile, further strong growth in U.S. demand would, if past relationships hold, produce another step-up in our imports. However, the question of whether earlier relationships still hold is difficult to answer. The projection of imports includes two new developments. First, imports of oil and gas are beginning a spectacular rise; by the end of 1973 such imports will probably be at an annual rate of over $6 billion, about double the 1970 rate.

The second new factor is the effect of the exchange rate adjustment of last year, and as you are well aware there is little in our experience that helps in making a judgment about such effects. In principle, it would be expected that a devaluation would first raise import prices and then, over time, cause a drop in the quantities imported, as domestic production replaces imports. Prices of U.S. imports of finished manufactures have been rising rapidly since 1969. So far this year, despite the dollar devaluation, these prices have risen only a little faster. As price increases abroad have accelerated, it appears that in general foreign producers have been absorbing some of the price increase, especially since they are not faced with strong domestic demand, and U.S. distributors have also absorbed some of the price increase. Evidence of these reactions is given by the replies made by business directors of the Reserve Banks and by members of the Federal Advisory Council to the recent inquiry initiated by the Board.

Though the devaluation effects on imports have been small so far, we expect that the decreased profitability of foreign exporters' sales to the U.S., and the increased competition from U.S. producers, will have a sizable impact on imports of consumer goods by next year. Though U.S. demand for imports of industrial materials and foodstuffs will be rising, aggregate imports are projected to be no longer increasing more rapidly than total GNP.

The trade balance we have projected for 1973--a deficit of some $4-1/2 billion--includes an allowance of over $2 billion for the full year as a favorable exchange rate effect. By the fourth quarter of next year the exchange rate effect is favorable by about a $5 billion annual rate, about equally divided between exports and imports.

Current account transactions apart from merchandise trade are not expected to change much, in the aggregate, in the period ahead. Gains in investment income receipts, which will be bolstered somewhat by the higher dollar equivalent of foreign currency earnings, are likely to be offset by higher interest rates on our rising debts to foreigners. Net military expenditures abroad are not expected to decline much, even when hostilities in Indo-China are ended.

Turning next to the outlook for flows of long-term private capital--on the assumption that they will be proceeding under orderly capital market conditions--we do not see grounds for expecting much shifting in the over-all pattern or level of these flows. Outflows by U.S. companies are expected to rise from the rather low amount now projected for 1972. The strength of the economic upturn abroad will probably cause a step-up in their capital outlays abroad.

Inflows of foreign private capital are projected to dip slightly next year, mainly because of an expected decline from this year's high rate of foreign purchases of offshore issues of U.S. corporate bonds. Net foreign purchases of corporate stock in the U.S. market are projected to hold at about $1-1/2 billion. On balance, the net outflow of long-term private capital may be about $2-1/2 billion in 1973, somewhat greater than the estimate for this year.

It is also necessary to take into account, in the year ahead, a programmed increase on the order of $1 billion in U.S. Government grants and credits. Major items in the increase are the financing of agricultural exports and an increase in Export-Import Bank credits--offsetting some of our export gain--and an allowance for rising economic aid to Vietnam, plus additional subscriptions to international lending agencies.

The sum of all the transactions that I have mentioned--that is, all transactions other than short-term capital flows and reserves transactions, the so-called basic balance--is expected to improve very little in 1973 from the $11 to $12 billion record deficit likely for this year.

I should note that projections of this deficit have been moved up several times since the chart show last June, when it was put at about $5 billion. The main elements causing changes have been the higher-than-expected trade deficit this year, rising oil imports, a sizable reduction in projected net income receipts, and somewhat higher outflows for both private and Government capital.

The persistence of a basic deficit of this size obviously raises a strong possibility that speculative pressures will recur. It is true that since mid-July the dollar has gained in strength against currencies except the yen, and inflows of short-term capital have offset most of the underlying deficit. Indeed, there has been a considerable resurgence of confidence in the dollar. However, interest rates abroad are rising as European countries intensify their anti-inflationary efforts, so that it is difficult to foresee whether the flow of liquid funds will be a stabilizing influence next year.

The situation we have been describing is obviously potentially volatile. For instance, we are projecting a basic deficit this year, and again next year, nearly as large as our total reserve assets, which now stand at about $13 billion. There may be changes in the situation that would be constructive--such as a further Japanese yen revaluation. But our projections suggest that while some of the necessary adjustment to achieve equilibrium in the U.S. balance of payments is forsee-able for 1973, an even larger part lies still further ahead.

Mr. Gramley made the following comments on policy issues:

The staff outlook for GNP presented earlier assumed Federal budgetary outlays of $253 billion for fiscal 1973. This is our judgment as to the most probable course of fiscal policy, but clearly there are other possibilities.

As against the estimate of $253 billion in our base model, it is possible that the Administration will be fully successful in its effort to hold outlays to $250 billion. If that degree of additional restraint were to continue throughout calendar 1973, Federal NIA expenditures by the fourth quarter of next year might be running about $6 billion below the base model estimate. Conversely, if the effort to control expenditures proved relatively unsuccessful, fiscal year outlays could easily rise to $256 billion, which could put NIA expenditures about $6 billion above the base model figure by the end of the calendar year.

In these two fiscal alternatives, the effects on purchases and other expenditures are not symmetrical, because our base model already assumes a tight rein on purchases. Further cuts would be likely to fall mainly in other areas, particularly in categorical grants to State and local governments.

The staff has developed projections, based on our econometric model, of how these alternative fiscal policy courses might affect GNP, the unemployment rate, and the deflator--assuming a 6 per cent growth rate of M_1. By the fourth quarter of 1973, current-dollar GNP might be running about $11 to $12 billion above or below the base model forecast--depending on which of the two alternative courses of fiscal policy emerges. This difference amounts to only 1 per cent of GNP, but its effects on resource utilization and prices would be noticeable. Take the unemployment rate, for example. In the model with more fiscal restraint, the unemployment rate would be projected to remain above 5 per cent throughout next year. In the model with less restraint, a decline in the unemployment rate to about 4.6 per cent by the fourth quarter would be implied.

The effect on prices would be smaller, and would show up mainly in the latter half of 1973. By the fourth quarter, our base model has the fixed-weight deflator for private GNP increasing at a 3.9 per cent annual rate--the alternatives are 3.6 per cent with more fiscal restraint and 4.2 per cent with less.

These are all very rough estimates, but they suggest that the room for error in stabilization policies may be rather small at this juncture. A little less fiscal restraint than assumed in the base model could threaten renewal of excess aggregate demand late next year; a little more could leave unemployment unacceptably high.

Monetary policy, therefore, will have to be prepared to lean in one direction or another, depending on the course of fiscal policy that actually emerges. Consequently, the staff has examined the implications of three different monetary policy alternatives--indexed by 5, 6, and 7 per cent growth rates of M_1.

Since the effects on real output and prices of a given change in aggregate demand are essentially the same for both monetary and fiscal policies, we can focus our attention on current-dollar GNP. By the fourth quarter of next year, current-dollar GNP would be about $7 billion more if the growth of M_1 were raised from 6 to 7 per cent next year, and $7 billion less with a 5 per cent growth rate. These numbers are smaller than the projected effect on nominal GNP of the alternative courses of fiscal policy considered. Thus, if Federal budgetary outlays turned out to be $250 billion, instead of the $253 billion assumed in our projection, growth in M_1 would have to be increased by more than 1 percentage point to offset the effect on GNP.

The discussion thus far has not dealt with estimates of the behavior of interest rates. The omission was deliberate. How interest rates are likely to react next year is a difficult question, to which we turn now.

Let me state our conclusions first, and then indicate how we got there. Our projections for interest rates assume 6 per cent money growth and a $253 billion level of Federal outlays. The 3-month bill rate rises to a range of 5-1/4 to 5-1/2 per cent by mid-1973 and to around 6 per cent by year-end. Long-term rates--exemplified by the rate on new issues of Aaa utilities--are projected to rise very little. The mortgage rate, under these circumstances, would increase hardly at all, and savings inflows to nonbank intermediaries, though reduced, would remain fairly sizable.

These judgments about interest rate prospects reflect a weighing of evidence from a variety of sources--our econometric model, rules of thumb about income velocity, and a flow-of-funds projection. Income velocity is projected to rise fairly rapidly next year--since nominal GNP increases at a rate of around 9 per cent while M_1 grows at 6 per cent. Past experience suggests that this would mean increasing interest rates, especially short-term yields.

A similar conclusion emerges from an analysis of the flow-of-funds--particularly in the share of funds to be supplied by households. The credit flows consistent with our GNP pattern could be met only by inducing households, through rising market interest rates, to buy market securites in moderate amounts next year--in contrast to the net liquidation that occurred in 1971 and the first half of 1972.

While the direction of short-term rate movements seems clear, the amount is uncertain. A 3 per cent rise in income velocity, as projected, sometimes has been accompanied by pronounced rate pressures. But income velocity has risen substantially over this past year or so, and yet short-term rates now are below August 1971 levels. The reason is that the demand for money has been weaker than expected on the basis of historical relationships.

To illustrate, if actual growth rates of M_1 and the rates predicted by our quarterly econometric model are compared, it is evident that the forecasting record has been poor since mid-1971. Actual growth in the money stock fell short of the predicted amount in each of the past five quarters--and the shortfall since mid-1971 has cumulated to nearly $10 billion. We have no good explanation as to why the demand for money has been so weak.

Our projection of short-term interest rates assumes that growth in money demand will be somewhat stronger than during the recent past, but still relatively low by historical standards. A good deal more pressure on short-term rates could result if that assumption is wrong.

On the other hand, we feel more confident in the judgment that pressures on long-term rates will be moderate next year if short-term rates do not rise sharply. For, in the absence of anticipatory long-term financing by businesses and other borrowers, the supply of new long-term securities seems likely to be small.

Nonfinancial corporations are projected to experience a somewhat greater increase in investment next year than in gross retained earnings, but the excess rises little for a period of strong business expansion. Consequently, total funds raised by nonfinancial businesses should not increase much, and bond issues are projected to stay near the recent subdued pace. This projection is consistent with further increases in corporate liquid asset holdings.

We expect some further diminution in municipal long-term security volume next year, also. The NIA surplus of State and local governments will decline when the retroactive payments under revenue sharing are completed, but the surplus should still be quite high late next year. Additionally, liquidity positions of State and local governments have improved a good deal recently, and capital expenditure requirements are less pressing now than a few years ago; these factors, too, should hold down long-term municipal borrowing.

If this view of prospective interest rate developments is correct, a 6 per cent growth rate of M_1 would be associated with relatively little additional financial restraint next year. This general conclusion could be upset, however, if money demand returns to its more normal relationship with GNP.

Mr. Partee made the following concluding comments:

The performance we envisage for the economy over the next five quarters is, on balance, quite favorable. Real GNP is expected to advance at rapid rates in the current and succeeding two quarters, reducing the degree of slack in labor and other markets. Thereafter, the rate of real growth seems likely to moderate as the special supplements to income end. If the rate of expansion moderates in the second half to approximately our longer-run growth potential, as we have projected, the re-entry problem will have been negotiated successfully.

The expansion we expect over the coming year is also comparatively well-balanced. Growth over the next five quarters in real outlays for business fixed investment and consumption are expected to match those of the past year. Residential construction declines, reversing the sharp upward trend of the past year or so, as the backlog of housing demands is filled. Inventory investment contributes no more to real GNP growth than it has in the past year, as stocks of inventories rise apace with expanding sales. Only State and local government expenditures are projected to rise somewhat more rapidly than in the immediate past, reflecting the improvement in financial capacity stemming partly from revenue sharing. I might add also that the marked improvement projected in the foreign trade balance would be a positive factor for domestic business, even though the over-all payments deficit may remain distressingly high.

The constraints assumed on Federal spending will not prevent large cash deficits in this and the next two quarters. But the effect of these deficits on economic activity and the credit markets may prove to be less than had earlier been feared. To a substantial degree, the deficits are likely to be offset by increases in State-local surpluses--stemming in large part from retroactive revenue sharing payments--and in personal saving, reflecting our assumption that the marginal propensity to save increased tax refund checks may be on the order of 50 per cent. If these savings materialize, we may be able to get through the spring without an excessive burst in consumer spending and without intense pressures on credit markets and interest rates.

This presumption epitomizes the caveat that we all have about our current projection. There are many points at which things could go wrong, and they seem for the most part to suggest that our outlook could be erring on the conservative side. Take the tax refund. The University of Michigan survey referred to by Mr. Wernick indicates little awareness of overwithholding; only a very small proportion of taxpayers have adjusted their exemptions upward, and fewer as of August were expecting tax refunds in 1973 than received them in 1972. This suggests that the increase in tax refunds will come as a complete surprise. We believe that we have allowed for that in assuming a substantial incidence of expenditure from the windfall. But suppose that taxpayers, finding that they have been substantially overwithheld in 1972, file amended exemption forms along with their tax returns. We haven't allowed for that to any significant degree, and the result would be to raise disposable income in 1973--and presumably current spending--relative to the personal income flows generated by projected economic activity.

Similar errors may have crept into other demand sectors in our projection. We continue to project a declining trend in housing starts--as we have confidently been doing for some time now--but current starts and permit figures seem surprisingly strong. Perhaps we have underestimated housing demand in a prosperous environment, or perhaps we have underestimated the ability of multifamily starts to stay high in the face of rising vacancy rates. Business capital spending could also turn out to be higher than we are projecting. Our expectations are a little high compared with the most recent surveys, and quite high in relation to the average of past experience, but major upward movements in capital spending sometimes have cumulated to reach excessive levels. And our projections of inventory investment, as noted earlier, are conservative in terms of implied stock-sales ratios, though they are no doubt still high in relation to current business thinking.

Even with no allowance for overruns, our economic projection implies a rather considerable rise in real output relative to potential by the second half of 1973, whether potential output is defined to be output at a 4 per cent unemployment rate, the usual measure, or whether a 4-1/2 per cent rate is used. It is not our function as a staff to set national targets for unemployment. But our analysis of the effects on the observed unemployment rate resulting from changes in labor force structure suggests that the pressures on wages and prices associated with a 4 per cent unemployment rate a decade ago are likely to develop at a higher rate under present conditions. The 4-1/2 per cent definition of potential output, which is consistent with an unemployment rate somewhat under 3 per cent for heads of households, allows for that structural change. Projected output approaches quite close to the potential at 4-1/2 per cent unemployment by the end of 1973.

Partly for this reason, we anticipate more upward pressure on prices next year, despite continuation of a controls program that will be exerting moderate restraint on wages and prices. Next year we are likely to face a juxtaposition of more rapid increases in employee compensation with a diminution in productivity gains. The social security tax increase--already a matter of law--will add substantially to labor costs as of the beginning of the year, as would an increase in the minimum wage which we anticipate later on. As for direct wage and benefit increases, some of the contract negotiations coming up seem certain to press very hard against any conceivable Governmental guideline, and there are likely to be many fewer instances of increases well below guideline levels than we have seen this year. Since growth in productivity usually declines at this stage of the cycle, unit labor costs are likely to be pressing upward on prices throughout the year. Our projected increase in the deflator, by the way, implies only a moderate rise in profit margins, even though aggregate profits advance substantially further with the projected increase in sales volume.

I am at a loss to say what aggregate demand policies can be expected to do about these excessive upward cost pressures. To resist them through smaller monetary expansion or more fiscal restraint would reduce real output gains and raise unemployment, without much likely short-run effect on the wage bargains being negotiated. We can, perhaps, hope that the controls program for 1973 will be stiffened, though that would run obvious risks that the pressures on the program at some point would lead to its collapse.

I continue to feel that our policy assumptions are realistic. If Federal expenditures can be brought under some restraint, and if a reasonably effective controls program can be continued, then I believe that monetary policy should continue into next year on a course marked by a 6 per cent growth in M_1. But we will have to monitor developments with respect to these other policy assumptions carefully. And we will have to watch to see that private spending does not develop significantly more strength than the staff is anticipating. If that should happen, the Committee might need to consider a rather prompt move toward somewhat greater monetary restraint.

At the conclusion of the presentation, Mr. Partee noted that a number of staff experts were present in order to help answer questions from members of the Committee.

Chairman Burns remarked that the staff deserved the Committee's appreciation for a comprehensive and illuminating analysis of the economic outlook. He then invited questions and comments.

Mr. Hayes observed that the staff projections of economic activity were closely in line with those made at the New York Bank. He then noted that for some time the Committee had been using a 6 per cent annual rate of growth in M_1 to symbolize its desired growth rates for the monetary aggregates. However, the economy had now emerged from a period in which the strength of the recovery was uncertain into one where all of the indicators were quite strong and where--as Mr. Partee had said--the risk was that actual rates of economic expansion might exceed projected rates. In that light, he asked whether it would not be reasonable to think in terms of a rate of growth in M_1 lower than 6 per cent--perhaps 5 or 5-1/2 per cent.

In reply, Mr. Partee noted that over the past year and a half the staff had not been suggesting that 6 per cent was the ideal rate of growth for M_1; in most of the chart shows, it had recommended a somewhat higher rate of growth in order to quicken the pace of economic recovery. In preparing the material presented at this meeting, the staff had evaluated the implications of rates of growth both higher and lower than 6 per cent and had concluded that at this time 6 per cent was about right--that it represented a reasonable trade-off between the need for further reduction in the rate of unemployment and the desire to avoid intensifying the difficult price problems ahead.

Mr. Mayo noted that the staff projections--based on an assumption of Federal expenditures of $253 billion--indicated a shift from a substantial high employment deficit in the first half of 1973 to a small surplus in the second half. He asked whether a high employment deficit might not re-emerge in the first half of 1974 as a result of overwithholding and refunds of taxes. If so, one could not derive much satisfaction from the nearly balanced position in the latter part of next year.

In reply, Mr. Wernick observed that the shift from a high employment deficit in the first half of 1973 to a surplus in the second half reflected the concentration of the unusually large tax refunds in the first half. Although the staff had not made estimates of the Federal budget into 1974, it seemed reasonable to expect that a continuation of overwithholding would again lead to refunds, and to a high employment deficit, in the first half of that year.

Mr. Mayo then asked about the implications that the alternative fiscal policy assumptions--expenditures of $250 and $256 billion rather than $253 billion--would have for the high employment balance in the second half of 1973.

Mr. Gramley replied that the alternative fiscal policy assumptions would add or subtract roughly $6 billion to the high employment surplus indicated for the fourth quarter of next year. Thus, instead of the surplus of $2 billion in that quarter indicated on the basis of Federal expenditures of $253 billion in fiscal 1973, there would be a surplus of about $8 and a deficit of about $4 billion, respectively, under the lower and higher assumptions for Federal expenditures.

Mr. Mitchell said he inferred that there was no realistic combination of fiscal and monetary policies that would bring down the increase in the fixed-weight GNP deflator to an annual rate of 3 per cent by the end of next year; had there been one, the staff would have presented it. He inferred further that the staff had concluded that policy for the period ahead had already been determined by an accident and by a deliberate action of the Congress--the accident being the overwithholding of income taxes this year and the deliberate action being the increase in social security taxes effective next year. Concerning the overwithholding, it seemed incredible that so few taxpayers had been aware of it and had taken action to correct it. He inquired how the assumed overwithholding was distributed among income classes and whether it was confined mainly to the lower income groups.

In reply, Mr. Wendel said both low and high income groups were affected. In the new withholding schedule introduced this year, the standard deduction was based on an assumption that every tax-paying unit had two income earners. Consequently, every unit that had only one income earner was subject to overwithholding. Although that feature of the new schedule affected all income groups, it affected more taxpayers in the lower income groups. In addition, the tax rates that underlay the new withholding schedule were more progressive than the old. Therefore, the higher income taxpayers who itemized deductions were more likely to be subject to overwithholding under the new schedule.

Mr. Partee observed that the information relating to the public awareness of the overwithholding of taxes came from an unpublished University of Michigan survey based on a very small sample. The Michigan surveys, moreover, generally had undersampled the higher income groups. Nevertheless, they usually had reflected public opinion in a general way. According to the survey taken in August, 16 per cent of taxpayers had filed forms changing the number of their exemptions, but most of those taxpayers had reacted to changes in family size. Ten per cent had filed forms reducing the number of their exemptions. Only 6 per cent of taxpayers had increased the number of their exemptions, and very few of them seemed to have done so because of the overwithholding problem. Another interesting result of the survey was that most respondents felt that the Federal tax burden had increased over the past 3 years whereas in fact tax rates had declined considerably.

Mr. Mitchell remarked that because of inflation and increases in incomes, many people were paying higher Federal taxes despite the reductions in rates. He then asked when information on the magnitude of refunds actually made would begin to become available.

Mr. Wendel replied that refunds typically were heavy in late February; at the beginning of March comparisons with experience in earlier years would provide some indication of the magnitude. However, firm data would not be available until April or May.

Mr. Brimmer asked what combination of policies would be required to achieve a greater reduction in the amount of unemployed human and material resources by the fourth quarter of 1973--including a reduction in the unemployment rate to 4 per cent. He was particularly concerned with that issue because it appeared that, although the performance of prices was likely to become less favorable, the rate of capacity utilization in manufacturing projected for the fourth quarter of 1973 still was no higher than

81 per cent and, with the labor force expected to grow by 1.7 million persons over the year, the unemployment rate was projected at nearly 5 per cent. In that connection, he wondered whether the staff had accepted the idea that an unemployment rate of 4-1/2 per cent was now an acceptable target. Even if the rate were to decline to 4-1/2 per cent by the end of 1973, four million persons still would be unemployed. It was true that young people were now a larger part of the labor force, but they were nevertheless seeking jobs. In any case, the adjustment for change in the composition of the labor force from that of a decade ago lowered the unemployment rate by only about a half of a percentage point. Moreover, he suspected that the unemployment rates of a decade ago should not have been considered as satisfactory.

In reply, Mr. Partee said the staff had not worked through a combination of policies that would bring the unemployment rate down to 4 per cent. In the light of previously expressed Committee views about the inflationary implications of such a combination of policies, it had not seemed to be a realistic alternative. However, the materials presented this morning suggested that the most expansive of the three fiscal policy alternatives combined with a monetary policy alternative represented by growth of 7 per cent--or perhaps 8 per cent--in M_1 would lower the unemployment rate to 4 per cent by early 1974. Such policies would substantially raise the rate of increase in prices from what it otherwise would be--perhaps not so much in 1973, but increasingly in 1974.

Mr. Brimmer agreed with that appraisal. He commented, however, that in his view the alternatives presented to the Committee focused more on the objective of holding down the rate of increase in prices than on that of reducing the unemployment rate further.

Mr. Morris observed that staff projections based on the most restrictive policy assumptions yielded higher rates of growth in GNP than any of the projections examined at the Boston Bank. He asked whether that reflected a staff assumption that the recent divergence of the demand for money from its long-term relationship to GNP would persist.

Mr. Gramley replied that the staff projections were, indeed, slightly higher than most published forecasts, but that was chiefly because of a more bullish appraisal of demands for goods and services in the private sector of the economy. An assumption that the demand for money would remain weaker than suggested by historical relationships did contribute to the growth rate projected; but the main consequence of that assumption was a reduction in the projected level of Treasury bill rates. Specifically, the 3-month bill rate in the third quarter of 1972, according to the quarterly model, had been about 75 basis points below the rate consistent with the historical relationship between money demand and GNP. It was assumed that less than half of that discrepancy would disappear over the projection period.

Mr. MacLaury asked what would be implied for the behavior of interest rates should they adjust to their historical relationship to the rates of growth in money supply and GNP.

Mr. Gramley replied that a mere return of interest rates to a historical relationship between the growth rates in money supply and GNP would add about 50 basis points to the 3-month Treasury bill rate. Thus, the bill rate would be about 6.5 per cent in the fourth quarter of 1973 rather than 6 per cent. If the past shortfall of money demand were assumed to be made up too, the rise in the bill rate would be greater.

Mr. Partee said he should remind the Committee that the staff projections of GNP for the next year were partly judgmental and were somewhat higher than those produced by the quarterly econometric model. The staff had been impressed with the cumulative forces of expansion; almost all indicators had been moving up sharply, and that was likely to have a psychological impact that would carry GNP to higher levels than indicated by past relationships. Moreover, the staff had given considerable weight to the expected refunds of overwithheld taxes in the first half of 1973. The University of Michigan survey referred to earlier had not been made public, and none of the private forecasters seemed to be fully aware of the effects that the refunds might have on consumer behavior in early 1973.

In response to a question by Mr. Sheehan, Mr. Partee observed that in Congressional testimony Treasury officials had tended to treat the overwithholdings as just another form of saving. Of course, Congress could again change the withholding schedule, but as far as he knew such a step was not under consideration.

Chairman Burns asked whether people who were saving without being aware of it might not simply continue to do so.

Mr. Mitchell remarked that the receipt of refund checks would induce them to reappraise their decisions with respect to spending and saving.

Mr. Gramley commented that past experience suggested that an individual who received a one-time windfall gain--such as a tax refund--would save a large part of it. In this case, however, the people who received an unanticipated refund of past withholdings were likely to realize that their current after-tax incomes were larger than the amounts of the paychecks. Consequently, they would be disposed to step up their spending.

Chairman Burns observed that a layman might very well accept a windfall in the form of a tax refund without appreciating its implications for his future disposable income. He wondered, in fact, how many working people really understood the tax-withholding procedure, and how many respondents in the Michigan survey understood the questions on that subject.

Mr. Mayo remarked that if many taxpayers receiving refunds reacted by filing the necessary forms to reduce current withholding, the impact on consumption expenditures could be important.

In response to additional questions, Mr. Partee said that the record provided few clues as to how people would behave. The main comparable experience of large windfalls was in early 1950 when National Service Life Insurance dividends were paid, but the effects of those payments were overwhelmed by the buying waves that followed the outbreak of the Korean War only a few months later. The staff had assumed that about half of next year's refunds would be saved and that the other half would be spent over several quarters. The staff also had assumed that people generally would behave as Chairman Burns had suggested--that they would not change their current withholding rates upon receiving refunds. If in fact they did change their withholdings, consumption expenditures could expand appreciably more than suggested by the projections. The personal savings rate projected for the first half of next year was quite high; in absolute terms, it would be about $25 billion higher in the second quarter of 1973 than a year earlier. That was an exceptionally high rate, and it suggested the possibility that consumer spending might rise too rapidly. A less rapid rise in disposable income would be desirable.

Mr. Heflin observed that over the past year policy had been relatively free of international constraints. To him, the most disturbing element in the staff's excellent presentation related to the balance of payment prospects. He was particularly concerned about the projection that the rate of increase in the fixed-weight GNP deflator would rise from its recent level of 2.5 per cent to about 4 per cent in a period in which this country's trading partners would be making efforts to reduce the rate of price increase in their own countries. That seemed to raise questions about the viability of the Smithsonian Agreement.

In response, Mr. Pizer said he might note that other industrial countries generally were experiencing a higher rate of increase in consumer prices than the United States, although the implications for relative prices of internationally traded commodities were unclear. It was true that those countries were taking anti-inflationary actions and that none expected prices to rise faster next year than they had this year--but the rates of increase this year were quite high. However, prospective developments in unit labor costs here and abroad pointed to a potential problem that would have to be watched. As had been described in the presentation, unit labor costs in the United States were expected to rise more rapidly in 1973 than this year. Abroad, however, unit labor costs were at an earlier stage in their cyclical upturn and would benefit from the availability of unused resources as a basis for expansion in output.

Chairman Burns noted that the staff's balance of payments projections suggested a deterioration from 1972 to 1973 of \$1.8 billion in the categories of U.S. Government grants and private long-term capital flows. He asked about the basis for that pessimistic projection.

In reply, Mr. Pizer noted that of the \$1.8 billion figure mentioned about \$1 billion was accounted for by an increase in Government grants and credits. That included a few hundred million dollars each for the financing of grain exports to Russia and for an increase in Export-Import Bank loans--both of which might be viewed as partial offsets to the balance of payments improvement expected from a rise in exports. Also included was about \$150 million for increased subscriptions to the Inter-American Development Bank and the Asian Development Bank, and \$200 to \$300 million in economic aid to Vietnam. Those estimates were based on figures obtained from the Government agencies responsible for the programs in question.

Chairman Burns remarked that the Congress might not make the funds available to permit the various agencies to spend as much as they now expected. He also was dubious about the projection of only a slight improvement from 1972 to 1973 in the foreign military transactions account, in view of the expected termination of the war in Vietnam and the possibility of some reduction of U.S. troop strength in Europe.

Mr. Daane said that when he was at Treasury some years ago he had understood the direct balance of payments effects of the Vietnam War then were estimated to be on the order of $1 billion to $2 billion, but that the estimated figure rose well above $2 billion when all the indirect effects were taken into account. He inquired whether a substantial part of the balance of payments gain had already occurred as the war had been wound down.

In response, Mr. Pizer said there had been a considerable gain this year from the winding down of the war, but the gain had been offset by a large rise in the direct costs of U.S. military operations abroad. That rise was attributable in part to increases in exchange rates for European currencies against the dollar, and the full impact of exchange revaluations had not yet been felt. Concerning the military programs, the balance of payments estimates had been developed by an interagency committee that had obtained estimates from the Department of Defense.

Mr. Partee remarked that the winding down of the war also had an impact on defense spending in the Federal budget.

Mr. Wendel added that spending for Vietnam was indicated to decline appreciably. However, spending for other defense purposes was indicated to rise and the total to be about unchanged.

Chairman Burns said it was his impression that defense spending related to Vietnam would decline by about $2 billion in fiscal 1973 and by about $6 billion in fiscal 1974. If those figures were correct, they might suggest a reduction of about $4 billion in calendar 1973.

Mr. Brimmer observed that the staff projections suggested that Government purchases of goods and services for defense on a national income accounts basis would rise from $76.6 billion in 1972 to $76.9 billion in 1973.

Mr. Partee noted that the projections included an allowance for a $1.8 billion military pay increase in 1973.

Mr. Wernick added that on a quarterly basis the projections suggested that the peak in defense expenditures reached in the second quarter of 1972 would not be exceeded next year.

Mr. Heflin remarked that, if the balance of payments projections proved to be correct, the Committee would have to watch developments in that area carefully in formulating monetary policy.

Chairman Burns remarked that at some point balance of payments figures of the kind projected for next year would become impossible. Perhaps, however, that time would not yet have arrived by 1973.

Mr. MacLaury remarked that the projected decline in housing construction presumably would be brought about by such factors as high vacancy rates in rental housing, and not by a shortage of funds. He asked whether that would not be an unusual development.

In response, Mr. Partee observed that in the mid-1960's a considerable slowing in housing construction had occurred before the availability of funds had become a constraint; particularly in California, housing starts had fallen sharply before money had become tight. In recent months housing permits and starts had remained high, but vacancy rates had begun to rise. Moreover, completions of housing units had not yet caught up to the high trend level of starts--apparently because of shortages of particular materials and skills--and a large rise was likely over the next 6 months. The effect of that rise on vacancy rates might be sufficient to influence decisions about new projects.

Mr. Gramley added that residential construction was one area where staff projections for next year were stronger than those of private forecasters. The latter also expected that a decline in activity would be brought about by demand factors--a rise in completions and in vacancy rates--rather than by a shortage of funds, and they foresaw a larger decline than did the Board's staff.

Mr. Balles said he also was unaware of any other projections as bullish as those presented today. He asked whether the staff had had an opportunity to consult with the Council of Economic Advisers or the Treasury about the projections of those agencies and, more generally, what the main points of difference were between the staff projections and those of other agencies and private forecasters.

Mr. Partee replied that he had not seen any specific projections by the Council or the Treasury; he believed they had not yet completed the assessment of the outlook they would make in connection with the forthcoming budget documents. From conversations with representatives of both agencies, however, he would judge that they were no less bullish than the Board's staff. Compared with the available private forecasts, the staff projections suggested somewhat faster growth in real GNP and about the same rate of rise in prices. The main point of difference was in consumption expenditures; the staff projected a larger rise, in the expectation of large tax refunds. However, the differences were really not very great. He might note that he had encountered very bullish expectations at a recent meeting of the Conference of Business Economists, attended by senior economists of major corporations.

Chairman Burns observed that there was a strong tendency among private economists--indeed, among all economists--to be less optimistic about the second half of a projection year than the first half. He suspected that if the first half of the year was considered alone the staff projections would not be found more bullish than those of others.

Mr. Partee remarked that he had not made such comparisons for half years, although the bearish bias among economists in looking further ahead was well known. However, he might note that the staff projections also showed slower growth in the second half than in the first.

Mr. Winn asked, with respect to the decline in housing activity, whether some casualties were likely to occur among construction companies and developers who had become overextended financially. Also, he inquired about the developments in the stock market that would be consistent with the GNP projections, and he asked whether the strong rise projected for consumption expenditures would be associated with a more-than-proportional expansion in outstanding consumer credit.

In reply, Mr. Partee observed that the projected decline in housing starts was not so large as to provoke widespread difficulties in the construction industry of a sort that would adversely affect lender attitudes and induce a constriction of credit. However, there were bound to be some incidents of financial distress among builders and promoters in localities where there had been overbuilding. Concerning the stock market, a continued rise in prices was likely; indeed, that was one of the factors contributing to the projected strength in consumption expenditures.

With respect to consumer credit, Mr. Partee continued, specific numbers had been worked up as part of the flow of funds projections. In association with the high level of sales of automobiles and other consumer durable goods next year, outstanding consumer credit was projected to rise more than in recent years. However, the staff had not assumed a breakthrough on financing terms for new autos from 36- to 42- or 48-month maturities, and therefore the projected rise in credit was not expected to be disproportionately large.

Mr. Hayes referred to the earlier discussion of the normal demand for money in relation to growth in GNP, and observed that a strong upswing in economic activity generally was accompanied by a substantial increase in the income velocity of money.

He inquired what the staff projections for the year ahead implied for velocity.

Mr. Gramley replied that income velocity generally did rise in periods of cyclical expansion in activity. In those periods, interest rates also generally advanced. In the past year, however, a significant increase in income velocity had occurred without a rise in short-term interest rates; that was the departure from normal experience. In the coming year, the staff expected a reversion to the normal cyclical pattern in which the expansion in GNP and rise in income velocity were accompanied by some upward pressure on interest rates.

The Chairman then called upon Mr. Axilrod to begin the discussion of Committee procedures with respect to monetary policy targets and instructions to the Manager.

Mr. Axilrod made the following statement:

> Perhaps it would be most useful for the Committee's discussion of procedures for setting open market operating targets if I were to provide a brief description of the staff's understanding of these procedures and how the material presented to the Committee, mainly in the blue book,1/ relates to them. Obviously the Committee sets its short-run operating instructions against the background of its goals for the economy and the financial conditions that appear consistent with these goals. I need not recapitulate this background; the chart show presented today has been illustrative.
>
> The procedures for establishing operating targets have, of course, in recent years involved increased emphasis on monetary aggregates. This has led--pretty much as a natural corollary--to increased emphasis on

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

bank reserves in guiding day-to-day operations, and since February of this year to the particular measure of reserves represented by RPD's.

At the same time the Committee has retained its concern with money market conditions, and with over-all credit market conditions. It has felt free to shift its emphasis between monetary aggregates and interest rates depending on the nature of economic and financial circumstances, such as even keel, foreign exchange crises, particular credit market disturbances (e.g., the Penn Central crisis), and uncertainties as to the basic strength of the economy or the underlying demand for liquidity. But such shifts in emphasis have generally recognized that objectives for the aggregates are thought of as targets over a longish period--say, 3 to 6 months--in the belief that short-run variations in monetary aggregates have little significance for economic behavior.

To facilitate Committee discussions of its operating objective under the circumstances, the blue book prepared by the staff has normally contained at least three alternatives, each of which has indicated, hopefully, a consistent set of relationships among monetary aggregates, bank reserves, money market conditions, and interest rates more broadly. These relationships are the element of projection in the blue book. Put simply, we are not projecting growth in M_1, and we are not projecting interest rates. We are projecting the relationship between growth in M_1 and interest rates.

Thus, if the Committee wishes to adopt particular rates of growth in the aggregates as a target, the blue book would show our best estimate of the RPD's needed to attain them and the likely effects on interest rates and money market conditions. Among the alternatives, we have always included one which encompasses prevailing money market conditions, so that the Committee would also know our best estimate of growth in the aggregates given prevailing money market conditions and projected GNP growth. This type of projected relationship--estimates of the aggregates given prevailing money market conditions--is what has been most commonly referred to as "the projections".

In presenting alternatives that are useful to guidance of Desk operations in the interval between Committee meetings, the staff has of necessity developed estimates of short-run paths for the aggregates that appear consistent with longer-run objectives. The specification of these paths--which are designed to minimize the chances for money and credit market disturbances--takes account of the lagged relationship between interest rates and the demand for money. In addition, short-run movements in money are also influenced to a degree by such factors as Treasury cash management policy as well as by random factors that we cannot, by definition, predict. Because of the large erratic factors affecting changes in money, the staff has felt that even over the short run it was more meaningful to average out; so that in the last two blue books we have shown short-run ranges of money supply growth over 2-month periods.

The behavior of monetary and reserve aggregates in the short run is in turn associated with a behavior of money market conditions. What we have presented in the blue book has been our best estimate of what is likely to happen to, say, the funds rate at the particular growth in RPD's thought needed to attain various objectives for the monetary aggregates. Occasionally we have given a point estimate of the funds rate. Mostly, we have presented a range. The range reflects an allowance for error, but it also reflects the extent to which we believe the funds rate may have to rise or fall from prevailing levels. In other words, the funds rate range is pretty much technically determined.

This technical estimate is to be distinguished from how much weight the Committee may decide to give money market conditions on policy grounds. For example, the Committee may wish to limit the permissible range of fluctuation in the funds rate because of concern with credit market conditions or because of a wish to delay reactions until doubts about projected relationships between aggregates and interest rates are resolved. On the other hand, if aggregates had been for some time over- or under-shooting the target, the Committee might wish to permit a wider range of variation in the funds rate so as to be more certain of achieving reserve and aggregate objectives.

Similarly, the Committee on policy grounds may widen or narrow ranges of tolerance around reserve and monetary aggregates for purposes of operations over the intermeeting period. Or it may wish to make these ranges asymmetrical--for example, skewing them downward from longer-run desires if recent growth has been excessively high or skewing them upwards if recent growth has been excessively low.

The blue book can be viewed as a menu of consistent targets--and we tried to make that even more explicit in the blue book presentation for this and the previous meeting. The Committee is, of course, free to pick and choose among the various objectives presented, taking due account of the risks being run. There is the risk, for instance, of choosing incompatible objectives. However, this risk has to be weighed against the probability that there will be errors in the staff's estimates of relationships likely to prevail among bank reserves, monetary aggregates, and interest rates--not to mention the existence of differing estimates.

The possibility of errors in estimated relationships and of choosing incompatible objectives makes it all the more essential for the Committee to specify its order of priority and ranges of tolerance when establishing objectives. It also indicates that a mechanism for reconsideration needs to be in place during the inter-meeting period. All of these conditions have been fairly well met since the aggregates and RPD's have received greater emphasis.

What has particularly evolved in Committee discussion over the past year, it seems to me, has been a clearer differentiation between targets (what in essence the Committee wants) and projections (what the staff thinks is a consistent set of financial relationships over time). I do not believe that this distinction is novel. The Committee has always been engaged in setting targets, and the staff has always attempted to provide the necessary informational background to permit consideration of realistic policy alternatives. But in recent meetings the Committee has appeared to be making a more explicit effort (1) to avoid accepting short-run projections of aggregates as targets; (2) to be clearer as to its own preferences over both the short and longer run, expressing short-run preferences, for instance, in ranges of tolerance (possibly skewed high or low) for key variables; and (3) to allow enough short-run flexibility in ranges for, say, money supply as variously defined or for the Federal funds rate so as to provide the Manager with the latitude that will permit open market operations to be carried out smoothly.

Mr. Holmes made the following statement:

Speaking for those of us at the Trading Desk, our understanding of the Committee's procedures coincides with the one Mr. Axilrod just outlined.

We have had surprisingly little trouble in day-to-day operations at the Desk under the procedures that have been developed this year. To some extent this has been good fortune since growth rates of the monetary aggregates have moderated with less upward pressure on interest rates than had been anticipated. Because the Committee has multiple objectives or targets, it is always possible that conflict may arise in trying to achieve all of them. The Committee's current instructions allow room for some trade-off among objectives, and the possibility of a special consultation in between regular Committee meetings, if the Chairman deems it advisable, allows ample protection against a basic conflict among objectives that lasts too long.

While the new procedures have not been a problem so far for the Desk, this does not imply that we have not frequently had the usual problems of forecasting the factors outside our control that affect reserve availability. As a result we have had to be quite flexible in our approach to operations, but I can think of no major problems that this flexibility has given rise to.

There have also been differences in projections of the relationships among reserves, monetary aggregates, and interest rates between those made by the Board staff and those made at the New York Bank. This is certainly to be expected since forecasting these relationships is far from an exact science. I find it useful to work with two sets of projected relationships, even though reconciling the differences between them is not always an easy matter. With the Committee placing greater emphasis on achieving desired growth rates over a longer term, I suspect that we will frequently run into problems of measuring just where we stand at any given point of time relative to the longer-run target. Working with a 2-month operating range, as Mr. Axilrod noted, reduces to some extent the possibility that a single month's aberration may lead us astray. But even a 2-month deviation from trend may not be significant, and we shall have to try to increase our ability to distinguish between meaningful and insignificant short-run deviations from the Committee's targets.

> While the Committee has placed a new emphasis on RPD's, I think it has made it quite clear in its instructions to the Desk that RPD's are not an end in themselves but a handle to achieve desired growth rates in the aggregates. If relationships between reserves and aggregates turn out differently from those anticipated, we should look through RPD's and be content if the desired growth rates for the aggregates are being achieved.
>
> Because of the problem with our projections of reserve factors outside our control that I noted earlier, we have sometimes had to operate by ear--allowing the money market itself to guide us as to the actual reserve availability at any given time. I would like to make clear that this does not mean that we are using the Federal funds rate as a target. On many occasions, in fact, we find the Federal funds rate to be a very useful guide to the availability of reserves in the banking system,which is the Committee's primary area of concern.

Mr. Eastburn, noting that Mr. Holmes had said that he sometimes relied on money market conditions as a guide to reserve availability, asked why the reserve figures themselves were not available for that purpose.

In response, Mr. Holmes observed that at the beginning of a statement week estimates of reserves had to be made for the entire week. As he had reported on other occasions, the average error in the estimates made on the first day of a statement week was a quarter of a billion dollars. Moreover, estimates for the week made at the Board and at the New York Bank sometimes differed by substantial amounts. In those circumstances, short-run movements of the funds rate often provided a good--although by no means a perfect--clue to reserve availability.

Mr. Daane asked whether--in view of the role attributed to the Federal funds rate by Mr. Holmes--the ranges specified for the rate were not unrealistically wide, even though they had been narrowed to 1 percentage point or less from 1-1/2 earlier in the year.

Chairman Burns observed that while the specified range for the funds rate might be a percentage point the potential movement to either limit from the level prevailing at the time of a meeting generally was significantly less than that. In his view it ordinarily would be unwise to provide for a movement of as much as a full percentage point in the interval from one meeting to the next. Even in circumstances when the Committee wished to specify targets for the aggregates that--according to staff projections--would be associated with that much short-run movement in the funds rate, it generally would impose a constraint that would limit the movement to less than a percentage point.

Regarding the realism of the range, Mr. Axilrod commented that there had been occasional 4- or 5-week periods in which the funds rate had moved by as much as a full percentage point, and there had been many more instances when the rate had moved 1/2 or 3/4 of a point. At times, prevailing circumstances permitted that much movement in the rate without severe disruption in the market.

On the technical level, Mr. Axilrod continued, the staff endeavored to present in the blue book its best estimates of the interest rate pattern that appeared likely to develop in association with specified paths for the aggregates. If the staff narrowed or otherwise adjusted those estimates before presenting them in the blue book or elsewhere, it would not be properly informing the Committee. Once so informed, of course, the Committee might shade the ranges if it wished to do so for policy reasons.

Mr. Daane asked Mr. Holmes whether, from his point of view, the Committee in fact had moved over the past year more towards a Federal funds rate constraint, if not a target, and whether the market was placing that interpretation on events.

Mr. Holmes replied that he did not think so. To be sure, the degree of movement in the funds rate between Committee meetings had been little different this year from last, but that had resulted from good fortune in being able to achieve more or less the desired rates of growth in the aggregates without sharp movements in interest rates. That good fortune might not persist. If a conflict arose in the months ahead and if it appeared to him that it would be necessary to allow the funds rate to move substantially toward the specified limit, it would be the time, in his view, for consultation--unless at its previous meeting the Committee had clearly indicated its willingness to accept a sizable movement in interest rates.

Mr. Hayes commented that he, like Mr. Daane, thought that a funds rate range of a full percentage point was too wide. In practice, on the other hand, the range sometimes was quite narrow. At the last meeting--and he had not objected--the Manager in effect was told to hold the funds rate fairly close to its prevailing level of about 5 per cent unless growth in RPD's or the monetary aggregates appeared to approach the limits of the ranges specified.

Mr. Daane remarked that he thought the range for the funds rate needed to be narrowed but not to an extent that interfered with the Manager's ability to operate flexibly in the market.

Mr. Holmes commented that as long as the Committee agreed that the RPD target and the funds rate constraint could not be rigidly adhered to on a weekly basis, operations were not unduly constrained. In the latest intermeeting interval, the funds rate had averaged just a shade over 5 per cent although the rate had varied from an average of 4.86 per cent in one week to 5.25 per cent in another.

Mr. MacLaury remarked that he agreed with Mr. Axilrod's judgment that in certain circumstances a change in the funds rate of 1 percentage point within a 4- or 5-week period was not excessive.

With respect to the Committee's operating target, he wondered whether the effort to adjust the RPD range for unexpected shifts in the relationship between RPD's and the monetary aggregates did not amount to using the aggregates themselves as the operating target--which, he observed, did not disturb him. He then asked Mr. Holmes how he interpreted the relationship between the Committee's objectives for the aggregates and its constraint for the funds rate. Specifically, he inquired whether the Manager would allow the funds rate to move further within its specified range as the rates of growth for the aggregates appeared to stray further from the midpoints of their ranges, and whether he would permit the funds rate to move even faster toward its limit if growth in RPD's appeared to be outside its specified range.

Mr. Holmes replied that in general the answers were yes. At the last meeting, however, the Committee had made explicit its desire that there be no more than a modest movement in the funds rate so long as the aggregates were within their ranges--that the funds rate should be allowed to move more substantially only if the aggregates appeared to be moving outside their specified ranges.

Mr. Axilrod added that RPD's were an alternative to the funds rate as an operating handle, and they did bear a relationship--although not always a consistent one--to the monetary aggregates. Without the reserve handle, judgments had to be made about how much change in the funds rate was required in order to achieve the Committee's objectives for the monetary aggregates. With emphasis on the reserve handle, however, a priori judgments about the funds rate became less important; the rate of growth in RPD's could be changed within its specified range, up to the point where the limit of the specified range for the funds rate became a constraint.

Chairman Burns remarked that at the last meeting he had initially defined the ranges for the aggregates as zones of no action. He had then modified that--in response to Mr. Holmes' remarks--to provide for a movement in the funds rate of up to but no more than 1/8 of 1 percentage point as the aggregates approached their limits. In the event that the aggregates appeared to be moving beyond their ranges, however, full and free use was to be made of the range for the funds rate.

Mr. Holmes observed, concerning Mr. MacLaury's remarks about the multiplier, that RPD's were not an end in themselves but were a means for achieving the desired rates of growth in the monetary aggregates. Therefore, deviations in the multiplier from expectations should not influence operations significantly as long as the aggregates themselves were behaving as desired.

Mr. Hayes asked Mr. Axilrod whether it was not also true that the use of the funds rate as an operating handle could enable the Manager to observe the response of the monetary aggregates to changes in the rate--to observe whether the aggregates were behaving consistently with the Committee's objectives.

Mr. Axilrod agreed, commenting that if one believed that the relationship between the funds rate and the monetary aggregates was more consistent than that between reserves and the aggregates, there would be no point to using the reserve handle.

Mr. Mitchell commented that starting with the proposition that the Committee had a reserve target based on the desired performance of the aggregates over a period of 3 to 6 months--which seemed now to have become a dogma--one could make short-run judgments whether developments were on target only by relying on projections for the aggregates. However, he would say without reservation that projections for the aggregates had been bad. Therefore, he believed that time was required to determine whether performance of the aggregates was on target, and the reserve targets ought to be held steady for a sufficiently long period. He did not believe--as seemed to be implied in the blue book--that Committee members could change their minds about the reserve target every 4 weeks, because of a high M_1 figure for a particular month or for some other reason. He thought, moreover, that the Committee had greater acuity of perception concerning money market conditions and interest rates and that it reacted more to those variables than to the aggregates as indicators of general monetary conditions. Consequently, he wondered whether on most occasions the Committee ought not to confine itself to a review of the past performance of the aggregates and to current projections of money market conditions and interest rates.

Mr. Axilrod observed that among the alternative sets of relationships between monetary aggregates and money market conditions presented in each blue book, there was always one that represented a continuation of the Committee's current longer-run target for the aggregates. There was always another alternative that represented a continuation of prevailing money market conditions. He agreed with Mr. Mitchell's statement that perception of the performance of the aggregates for a single month and projections for what the aggregates might be in the next month should not themselves be an occasion for changing the longer-run targets for the aggregates.

Mr. Morris observed that one objective the Maisel Committee on the directive had had in recommending a shift to reserves as an operating target was to lessen market sensitivity to the funds rate as an indicator of a shift in monetary policy. His own view was that the market now was less sensitive to relatively small changes in the rate, and he thought that had increased the Committee's flexibility in the formulation of policy. He asked Mr. Holmes whether he agreed with that assessment of the market response.

Mr. Holmes replied that to a degree the market had become less sensitive to small changes in the funds rate and that it was completely disregarding large changes in net borrowed or free reserves. In particular circumstances, however, the market might be watching the System for signs of a shift in policy, and it would still react to changes in the funds rate as an indicator. For example, if the aggregates had been growing rapidly, the market would begin to anticipate that the System would slow the growth in reserves and that the funds rate would rise. The market then would be watching the funds rate for confirmation of its expectations.

Mr. Brimmer said he was concerned with the distinction between operating targets contained in the instructions to the Manager--which he regarded as a technical matter--and the policy targets. Although the blue book provided a menu of operating targets, based on projections of the relationship between the aggregates and money market conditions, it left him without guidance as to what monetary policy ought to be. He would like to see more analysis of the appropriate targets for monetary policy and of the combination of monetary and fiscal policies to achieve various objectives with respect to GNP, employment, and prices.

In response, Mr. Axilrod observed that in the blue book prepared for this meeting the longer-run targets for the aggregates were more clearly associated with the short-run developments that reflected special and temporary influences--such as a December increase in private money holdings in association with a sharp drop in the Treasury's balance. Alternative B in the blue book specified growth in M_1 through the first quarter of 1973 at an annual rate of 6 per cent, which was consistent with the monetary assumptions that underlay the GNP projections presented in the chart show earlier in the meeting. And those projections in turn were used in assessing the interest rate implications--as described in the blue book--of a 6 per cent rate of growth in the narrowly defined money supply.

Mr. Partee added that there was always a tie between the monetary assumption underlying the GNP projections presented in the green book[1/] and the alternative monetary targets discussed in the blue book, although that tie was most clear on the occasions when the staff presented a chart show. Alternative monetary targets represented by annual rates of growth in M_1 at 5, 6, and 7 per cent had been presented in every recent chart show, and projections in recent green books had been based on an assumption of monetary growth

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

at a rate of 6 per cent. Concerning trade-offs between monetary and fiscal policies, the staff had given a fair amount of attention to the issue today because of its own uncertainty about what fiscal policy would be. Ordinarily, however, the staff did not go very deeply into the implications of alternative formulations because, obviously, the Committee could not control fiscal policy.

Mr. Brimmer observed that he had found today's discussion helpful. He hoped in the future the staff would share with the Committee--perhaps in an appendix to the blue book--the monthly projections so that those who wished to look at projections as opposed to targets, and at monthly as opposed to bi-monthly figures, could do so.

Mr. Partee remarked that he hoped everyone would view the monthly figures with the awareness that they were subject to a great deal of random variation. Personally, he preferred the 2-month averages.

Mr. Brimmer asked whether the use of 6-month targets for the monetary aggregates would pose problems in connection with the description of Committee decisions in the record of policy actions and the public reactions thereto. Specifically, when the policy record entry for a given meeting was published 90 days later, would the public be given a view of a 6-month policy target that still had 3 months to run?

Mr. Axilrod replied that while the Committee at each meeting needed to have some longer-run view of developments, it was taking policy actions only for the interval of time before the next meeting of the Committee.

Chairman Burns observed that in adopting a 6-month target, the Committee was not committing itself to work toward that target over the whole 6-month period. The Committee merely was expressing its present judgment with regard to the next 6 months, and at the next meeting it might have a different judgment. Over time, the 6-month target might change or it might remain constant.

Mr. Holland commented that as the Committee's views of the longer run had become more articulated, the staff had described them with a qualitative adjective. So far, the word "moderate" had described them very well. He assumed that the staff would continue to use a judgmental, qualitative adjective as long as that continued to serve the Committee's purposes.

Thereupon the meeting recessed until 9:30 a.m. the following morning, Tuesday, November 21, 1972. The attendance was the same as on Monday afternoon except that Misses Stockwell and Morrisse, Mrs. Junz, and Messrs. Grimwood, Ring, Zeisel, Taylor, Peret, Wetzel, Enzler, Wyss, and Promisel were not present and the following persons were present:

Mr. Reynolds, Associate Director, Division of International Finance, Board of Governors
Mrs. Stanier, Secretary, Office of the Secretary, Board of Governors

Mr. Cooper, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee on September 19 and October 17, 1972, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee on September 19 and October 17, 1972, were accepted.

Chairman Burns noted that Messrs. Daane and Mitchell had just returned from a trip to Europe, during which they had visited a number of central banks and had attended the November Basle meeting. Mr. Brimmer also was just back from Europe, where he had attended a meeting of the Economic Policy Committee of the OECD; and Mr. Mayo had recently returned from a trip to the Far East. The Chairman invited comments on any aspects of those foreign trips that were relevant to the Committee's policy problems.

Mr. Daane said he would submit for inclusion in the record a copy of the report Mr. Mitchell and he had made to the Board on their discussions with European central bankers.[1/] Today he would

1/ The report mentioned is appended to this memorandum as Attachment C.

touch on a few points regarding the November Basle meeting and Mr. Mitchell would comment on their joint visits to central banks.

In general, Mr. Daane observed, the Basle meeting was not particularly eventful. The discussion on Sunday afternoon was concerned in large part with the particular kinds of incomes policies being developed in individual countries to deal with inflation. There was considerable discussion of the British program, which had been announced publicly, and of the so-called "social contract" approach being tried in the Netherlands. That approach involved an agreement between labor, on the one hand, and the rest of the community, on the other hand, regarding the pace of advance in wages. The objective was to reduce the annual rate of increase in the wage bill to about 12 per cent from its recent much higher level. Obviously, the Dutch authorities did not consider a 12 per cent rate of increase to be satisfactory, but they did believe it would represent a step in the right direction. Perhaps Mr. Mitchell--or Mr. Coombs, who had also attended the Basle meeting--had some further comments on the "social contract."

Mr. Coombs remarked that the Dutch authorities themselves described the objective of the approach as that of "checking the dynamics of inflation." On the whole, he considered the program to be rather weak.

Mr. Daane then said he would make only one other point about the Sunday afternoon session, concerning the position taken by the Japanese representative. The latter noted that Japan's economy was expanding rapidly and that wages and prices were under upward pressure. For that reason he asserted categorically that Japan's future trade surpluses would not be nearly as large as outside observers were anticipating. The evening session was devoted wholly to an explanation by Mr. Mitchell and himself of the purpose of their visits to European central banks.

Mr. Mitchell said he might add with respect to the Sunday afternoon session at Basle that the United States had come in for high praise for its recent achievements in moderating the rate of price advance. After hearing the staff's presentation yesterday, he was not sure that praise was wholly warranted.

Mr. Mitchell went on to say that, as most members of the Committee knew, the discussions Mr. Daane and he had been holding with European central bankers were concerned with the operations of foreign banks in the United States and of U.S. banks in foreign countries. A number of questions were covered in the discussions, including those of initial entry, permissible activities, and regulatory standards. At present foreign banks were not permitted to operate in some countries, including Denmark and Norway, although the prohibition might be lifted in Denmark in connection with that country's imminent entry into the Common Market. Also, in countries where U.S. banks were permitted to operate they were not always entirely welcome. It was worth noting that in the United States there was no national policy at all with respect to the entry of foreign banks, since such banks were governed almost exclusively by State laws and regulations.

In the discussions of initial entry and permissible activities, Mr. Mitchell continued, Mr. Daane and he had suggested a reciprocal approach, under which there would be no discrimination within a country between foreign and domestic banks. That approach was accepted in principle by most of the central banks they had visited. It was not acceptable to the Swiss Banking Commission, however, and reservations were expressed by central bankers in some other countries--notably, those with nationalized banks now operating in the United States under State laws that gave them some competitive advantages over U.S. commercial banks. In the third problem area discussed--that of regulatory standards--he had been rather surprised to discover that Western European countries were already collaborating actively and expected their collaboration to increase.

In general, Mr. Mitchell concluded, there seemed to be considerable concern in all of the countries visited about the recent rapid growth of international banking. Officials in those countries had found themselves inadequately prepared for that development and were now attempting to assess the problems it had created and to explore means for dealing with them. The particular problem of most concern at the moment was that posed by flows of funds among units of large international institutions.

Mr. Daane said it might be worth noting that no public announcements had been been made regarding the discussions in question. It was desirable to continue to avoid disclosure until firm System views on the matters at issue had been developed, since premature disclosure could lead to misinterpretations.

Mr. Brimmer remarked that the main theme of the EPC meeting, which was held in Paris last week, was the recent record and outlook for inflation in the OECD countries. As at Basle, there was widespread admiration at Paris for the apparent success of the wage and price control measures adopted by the United States in August 1971. Britain's program was described as going some distance in the direction of the U.S. approach, and attitudes toward it seemed to be hopeful.

During the course of the meeting, Mr. Brimmer continued, the Austrians put forward a proposal calling for concerted action to stem inflation by the OECD countries. That proposal did not win acceptance; the general view was that the nature of the inflation problem differed so much from country to country that an effort at concerted action would be unwise. The brief position paper adopted at the meeting reflected that view, while noting that the Austrians had made a constructive contribution to the discussion. The U.S. representatives at the meeting did not agree to concerted action across international lines; rather, they encouraged each nation to take whatever measures it found feasible to deal with its own problems.

Mr. Brimmer noted that attention was called, in the documentation prepared for the meeting and in the discussion, to the existing margins of unused capacity in member countries, and the point was made that caution was needed to avoid stringent anti-inflationary measures that would cut off whatever further expansion might take place. It was agreed, however, that sometime soon--perhaps in 12 months in some countries, less in others--it would be necessary to place greater stress on checking inflation. The matter of unused capacity in the United States had been mentioned in the Committee's discussion yesterday; at this point he might simply note that the outlook for prices continued to be better in the United States than in other major industrial countries, even though the margin might be shrinking over the coming year.

The subject of capital controls also was discussed at the EPC meeting, Mr. Brimmer observed. The Secretariat had taken the initiative in preparing a paper on that subject, using information it had obtained from countries that had adopted capital controls in the last year or so. Those were mainly European countries interested in checking inflows of funds--primarily inflows that developed during periods of speculation. In the discussion, the French criticized the United States for not adopting controls, but they were not joined by others. The Germans and Swiss, who had been the leaders in imposing capital controls, expressed the view that such controls were undesirable and indicated that they hoped to remove them as soon as possible.

Mr. Brimmer remarked that there had been no criticism of U.S. monetary policy at the meeting. At one point, however, a member of the German delegation noted that interest rate differentials between the United States and Europe might widen over the year ahead as the Europeans pressed on with their campaign against inflation. He expressed the hope that in that eventuality U.S. monetary policy would be conducted in a manner that would prevent those differentials from widening very much, in order to help moderate their effects on capital flows.

Mr. Mayo remarked that he had spent last week in Tokyo and Osaka with a delegation from the "Midwest-Japan Association"--part of the Chicago Association of Commerce and Industry, of which he was a director. The primary purpose of the trip was to work toward a better understanding with Japanese financial, industrial, and Government leaders in regard to the desirability of their relaxing controls on inflows of American capital and exports. A parallel purpose was to encourage the Japanese to move forward energetically with the program, already announced by the Government, to reorient their economy away from Japanese exports and toward stimulation of both domestic personal consumption and socially-oriented Government spending.

Mr. Mayo said the Japanese now appeared in earnest about the need to turn a corner with respect to their balance of payments. Obviously, it would not be possible for them to eliminate their huge trade surplus overnight. Nor would it be desirable for them to do so, in view of their deficit on intangibles, and in view of the fact that the effects had not yet been fully realized of greater prospective competition from other countries in the Far East--notably Taiwan, whose economy still seemed quite healthy, and Korea, where economic development was strong. At present, efforts were being made to increase Japanese domestic expenditures in such vital areas as pollution control, mass transportation, housing, health, and community facilities. The programs announced to date probably could account for only a small part of the correction that would ultimately be necessary. They were in the right direction, however, and further measures would no doubt be taken later, after the Japanese election.

Chairman Burns asked Mr. Coombs whether he had any comments to add about the recent Basle meeting.

Mr. Coombs observed that the representatives of the Common Market countries devoted a good part of the weekend to negotiations concerning the so-called "snake in the tunnel." As he understood the outcome, they decided to maintain the 2-1/4 per cent band for exchange rates among their own currencies; they rejected a British request for a special exemption permitting a wider band for sterling; and, perhaps most importantly, they apparently agreed in effect to generalize to all Common Market countries the permission, previously granted only to Italy, to use dollars in market intervention operations directed at maintaining their 2-1/4 per cent bands.

The Common Market representatives also discussed the mode of settlement among themselves, Mr. Coombs remarked. He understood, however, that they remained at an impasse on that matter. That pointed up the fact that a good part of their reserves was, in effect, frozen; no country wanted to sell gold or SDR's. He was not sure what the ultimate outcome would be, but he suspected that as an interim solution the Common Market would move in the direction of exchange guarantees, possibly developing a mechanism within the Economic Community resembling the System's swap network. He thought the Common Market deliberations on that subject represented in microcosm the debates that would take place over coming months within the "Committee of Twenty" established at the recent meeting of the International Monetary Fund.

Finally, Mr. Coombs said, he received the impression at Basle that the British were not likely to end the sterling float until after the end of the year.

Mr. Daane said he had a similar impression regarding the sterling float.

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 October 17 through November 15, 1972, and a supplemental report covering the period November 16 through 20, 1972. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs remarked that the foremost topic of discussion in the exchange markets since the last meeting of the Committee had been the gathering momentum of European inflation. In most countries it looked like a rather virulent form of the disease which would not be easy to bring under control by either traditional or more direct measures.

So far as the dollar was concerned, Mr. Coombs said, European inflation cut two ways. On the one hand, the steady erosion in value of the European currencies naturally benefited the comparative standing of the dollar in the exchange markets, and the longer that European inflation continued at a rate considerably in excess of that in the United States, the greater the probable effect on the pattern of exchange rates. On the other hand, one European government after another was moving to tighten credit and otherwise to reinforce its efforts to check inflation, and that was naturally tending to push up European interest rates straight across the board. The European central banks were well aware, of course, of the risk of tightening credit to the point at which they might find themselves swamped with new inflows of hot money, and so far they had been moving fairly cautiously. However, there was always the risk that one central bank or another might inadvertently overdo things, as had happened in the past. That risk would be reduced, of course, insofar as the Europeans decided to emulate this country's example of price and wage controls. The British and Dutch had already made important moves in that direction but Germany, Switzerland, and France remained reluctant to follow suit and might continue to rely on traditional policy. The whole situation would bear close watching over coming months. He understood that differences of view were already developing among the senior officials of some European central banks as to whether they could safely take further actions to tighten credit. It was conceivable, in some instances at least, that at some stage a discreet word of caution by System officials might help to avoid unnecessary problems.

Meanwhile, Mr. Coombs continued, inflation and tighter money in Europe had generated cross-currents in the exchange markets which had tended to balance each other out, and there had been little net change over the past month in exchange rates for the dollar. To some extent also, the underlying buoyancy of the dollar on the exchange markets had tended to be limited by the policy the German Federal Bank had inaugurated a month or so ago of gradually selling off dollars as the dollar rate moved up closer to par. The market also expected the Swiss National Bank to offer dollars at rates not far above current levels.

In that more-or-less balanced market environment, Mr. Coombs observed, the System had not been able to acquire large amounts of the currencies in which it had debt outstanding. However, it had been possible to keep chipping away at the swap debt through daily market purchases of Swiss and Belgian francs, and it had repaid another $70 million since the last meeting. The over-all debt now stood at $1,630 million, a reduction of about 47 per cent from its August 1971 peak. The System had been pressing both the Swiss and Belgians rather hard to obtain clearance for its market purchases, and he did not think it could have insisted on doing more without damaging relationships and risking speculative reactions in the market.

Beyond the current situation, Mr. Coombs remarked, if some happy combination of events after the turn of the year should bring about major outflows of short-term funds from Switzerland and Belgium, there was likely to be still another impediment to taking full advantage of such outflows to pay down the swap debt. That was the problem of the very sizable uncovered dollar balances still held by the Swiss and Belgian National Banks, which amounted to $1.2 billion and $700 million, respectively. Both central banks were likely to take the position that they should have priority in selling off their uncovered dollars in the exchange markets if there were outflows, rather than giving the Federal Reserve full scope to buy their currencies and to reduce their covered dollars by paying down the swap debts. He had, accordingly, found himself wondering recently whether there might not be a case for issues to those central banks of medium-term Treasury dollar bonds incorporating a liquidity provision, as in the funding operation arranged with the German Federal Bank. Such medium-term issues might encourage the Swiss and Belgians to hold on to a sizable part of their present uncovered dollar balances and thereby clear the way for the System to take full advantage of future outflows from those countries to pay down its swap debt. He had not discussed that possibility with anyone else as yet, but he wanted to mention it to the Committee because it appeared at the moment to offer the main hope for making major progress in reducing the System's swap debt in January and February if in fact large outflows from Europe developed.

In reply to a question by Mr. MacLaury, Mr. Coombs said the dollar bonds that had been sold to the German Federal Bank had 7-year terms. Under the "liquidity provision" he had mentioned the bonds could be liquidated at any time, on 2- or 3-months' notice, in the event Germany encountered major balance of payments difficulties.

Mr. Daane asked Mr. Coombs to amplify his suggestion that System officials might want to warn foreign central banks against undue credit tightening.

In reply, Mr. Coombs observed that he had in mind a situation in which, say, a European central bank was contemplating a drastic tightening of monetary policy for domestic reasons, on the assumption that the action would not have serious consequences in the exchange markets. If Federal Reserve officials believed that assumption was mistaken he thought it might be appropriate for them to make their views known to the foreign central bank, since the interests of the United States as well as those of others were involved.

Mr. Daane remarked that Mr. Coombs' suggestion might prove to be a useful one at some point in the future. However, there had been nothing in the discussion at Basle to suggest any great concern at the moment about existing international interest rate differentials.

Mr. Brimmer agreed that the problem was not an immediate one. As he had indicated in his report on the EPC meeting, however, German officials were concerned about the possible effects on capital flows of additional European anti-inflationary measures. In that connection, it was worth noting that the German representatives indicated at the meeting that their country had no intention of employing the U.S.-U.K. approach to the inflation problem. It seemed likely to him that Germany would be following a much more restrictive monetary policy in, say, 6 to 9 months.

Mr. Coombs said he thought that development would come about sooner--perhaps in 2 or 3 months.

Chairman Burns remarked that the German authorities no doubt would consult with U.S. officials before they adopted such a policy.

Mr. Brimmer added that if any cautionary comments were to be made to foreign central bankers, they might well include a suggestion to the Japanese that they take stronger measures than now contemplated to reduce the size of their trade surplus.

It appeared from the discussion at the EPC meeting that the present measures would lower their surplus by about $1.2 or $1.5 billion, which was considerably less than the expansion otherwise expected in the year ahead. Thus, in the absence of additional measures, another sizable increase in Japan's trade surplus appeared to be in store.

Chairman Burns then observed that he had been wondering whether it might not be desirable at this point for the System to accelerate its purchases of Swiss and Belgian francs in order to pay off its swap debts in those currencies more speedily.

In reply, Mr. Coombs said it was his judgment, based on conversations with officials of the Swiss and Belgian central banks, that such a course would not be feasible under present circumstances. The System was now making daily purchases of up to $3 million Swiss francs and $1 million Belgian francs. In agreeing to the Swiss franc purchases the Swiss authorities had already made a considerable concession, since they had the alternative of selling off some of their large holdings of uncovered dollars. The program of Belgian franc purchases was going forward even though the market for that currency was small and the exchange rate for the franc was relatively high at the moment.

In his view, Mr. Coombs continued, there might be an opportunity for substantial repayments of the System's swap debts in coming months, if there were a strong recovery in confidence in the dollar and resulting large outflows from Switzerland and Belgium. As he had indicated, however, a conflict was likely to arise at that time between the desire of the Swiss and Belgian central banks to reduce their uncovered dollar holdings and the System's desire to pay down its swap debt. Those central banks were likely to argue that they had accumulated the uncovered dollars in question in the process of defending the dollar under the terms of the Smithsonian Agreement, and accordingly that they should have priority in selling dollars when the tide turned. While the System might respond that their dollar purchases since the Agreement were made in defense of their own currencies--that is, to prevent the exchange rates from rising to undesired levels--it was not at all clear how the issue might be resolved. There was a further technical point: because of time differentials, European central banks could operate in their markets hours before the New York market opened. Accordingly, they would have the first opportunity to take advantage of any sudden large outflows from their countries.

Mr. Coombs added that the problem was not simply one of the attitudes of the foreign central banks concerned. Obviously, it would not be in the interests of the United States for the System to acquire, say, Belgian francs in such volume as to drive the exchange rate for that currency to its ceiling. In deciding on the appropriate scale of purchases it was necessary to take account of probable market effects.

Chairman Burns asked whether any other members cared to express their views on the matter under discussion.

Mr. Hayes said he thought it would be appropriate to explore with the Treasury the feasibility of Mr. Coombs' suggestion that foreign central banks be offered the opportunity to fund holdings of uncovered dollars by purchasing medium-term dollar bonds from the Treasury.

Mr. Heflin suggested that the Committee plan on devoting an afternoon session some time soon to an in-depth review of the fundamental considerations relating to its responsibilities in the foreign exchange area. In his judgment such a review would be particularly helpful at this point in light of the problems that were likely to arise in that area over coming months.

Chairman Burns said that suggestion struck him as a good one.

By unanimous vote, the System open market transactions in foreign currencies during the period October 17 through November 20, 1972, were approved, ratified, and confirmed.

Mr. Coombs then noted that in the period from December 1 through December 29 all of the System's standby swap arrangements would reach the end of their terms, which were 6 months in the case of the lines with the central banks of Germany, France, Italy, and the Netherlands and one year in the other cases. He would recommend routine renewal of those swap lines for periods of up to one year. He might add that he had advised the Treasury that he planned to make such a recommendation today, and while he had received no formal expression of the Treasury's views, the preliminary reaction had been that the Treasury would have no objection to the renewals.

By unanimous vote, the Committee approved the renewal, for periods of up to one year, of the following swap arrangements having the indicated amounts and maturity dates:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Term (months)	Maturity date
Austrian National Bank	200	12	December 1, 1972
National Bank of Belgium	600	12	December 22, 1972
Bank of Canada	1,000	12	December 29, 1972
National Bank of Denmark	200	12	December 1, 1972
Bank of England	2,000	12	December 1, 1972
Bank of France	1,000	6	December 28, 1972
German Federal Bank	1,000	6	December 15, 1972
Bank of Italy	1,250	6	December 29, 1972

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Term (months)	Maturity date
Bank of Japan	1,000	12	December 1, 1972
Bank of Mexico	130	12	December 1, 1972
Netherlands Bank	300	6	December 29, 1972
Bank of Norway	200	12	December 1, 1972
Bank of Sweden	250	12	December 1, 1972
Swiss National Bank	1,000	12	December 1, 1972
Bank for International Settlements:			
Dollars against Swiss francs	600	12	December 1, 1972
Dollars against other authorized European currencies	1,000	12	December 1, 1972

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 October 17 through November 15, 1972, and a supplemental report covering the period November 16 through 20, 1972. Copies of both reports have been placed in the files of the Committee.

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

> A significant improvement in market atmosphere took place over the period since the Committee last met. Among the factors contributing to that improvement were the likelihood of a settlement in Southeast Asia, a strengthened feeling that greater progress was being made on the inflation front than had seemed likely earlier, a growing sentiment that the Administration would make a real effort to restrain spending, the increase in corporate liquidity that contributed to

a light corporate financing calendar, and the hope that the moderation in money supply growth meant that the Federal Reserve would remain on a steady policy course, at least for the period just ahead. Against this background, the expectation that a sharp rise in short-term rates and some upward pressure on long-term rates was likely in the last 2 months of the year began to evaporate. Interest rates actually showed a modest decline in all sectors, with the decline more pronounced in the longer-maturity areas.

In this atmosphere, the Treasury's November refunding was very successful, with the new 6-1/4 per cent 4-year notes currently trading at a premium of about 13/32 over the price established in the auction. In general, it now appears that the heavy Treasury financing in the last quarter of calendar 1972 can be handled by the market with little impact on interest rates. The announcement of plans for a $4.5 billion tax bill financing caused scarcely a ripple in the Treasury bill market--and the first $2 billion segment of that financing was successfully completed last Friday. In yesterday's regular Treasury bill auction average rates of 4.78 and 5.05 per cent were established for 3- and 6-month bills, respectively, down 5 and 9 basis points from the averages established in the auction just preceding the last Committee meeting. With two Treasury bill auctions scheduled this week, and next week as well, the bill market will be called on to absorb a large volume of new issues. But, at the moment at least, there seems to be a rather confident attitude prevailing about the market's ability to do so with perhaps only modest upward pressure on short-term rates.

How long this improved market atmosphere will prevail depends importantly on continued evidence that inflation is coming under control, on the progress made in restraining Government spending, on the strength of credit and money demand as economic growth continues into 1973, and, of course, on how accommodative monetary policy can be. It would scarcely seem possible that we could go through an extended period of vigorous economic growth without some further upward pressure on interest rates. So far at least, that pressure has not been nearly as strong as most market observers had anticipated.

With growth in the aggregates, particularly M_1, showing considerable moderation, as described in the written reports to the Committee and in the blue book, open market operations sought to maintain a steady growth in RPD's with the expectation that the Federal funds rate would stay around 5 per cent or a bit above. Until last Friday, RPD's appeared to be running in the lower end of the 9 to 14 per cent range of tolerance (adjusted for changes in Regulations D and J) adopted by the Committee at the last meeting. Last Friday's data, however, indicated a substantial shortfall in RPD's. The broader aggregate measures appeared to be on course, however, indicating that the problem lay in a sudden unexpected shift in the multiplier between reserves and deposits. Since the RPD target is a means to an end, and since the broader aggregative targets adopted by the Committee seemed to be doing reasonably well, there appeared to be no reason to make a change in the general stance of our day-to-day operations.

While the aim of open market operations remained steady over the period, actual operations had to take account of frequent unexpected changes in reserve availability and of the considerable uncertainty over the impact of the changes in Regulations D and J on reserves and also on bank attitudes in managing their reserve positions. Banks, too, appeared to be having as much difficulty with their reserve positions as we had in forecasting reserves, with the result that the Federal funds rate was not always the most accurate measure of reserve availability in the banking system. As a result operations had to be quite flexible with heavy reliance on the temporary injection or withdrawal of reserves. Thus, during the period, the Desk made more than $5 billion of repurchase agreements and $4 billion of matched-sale purchase transactions. Over the period as a whole, the Federal funds rate did in fact average slightly over 5 per cent, although the money market was a bit tighter in the week ending November 8 and a bit easier last week than we would have preferred.

Our ability to forecast float has been adversely affected by the change in Regulation J, and will remain so until new patterns have been established. Last week, for example, we had misses of plus or minus $1 billion on three consecutive days. As a result I expect that we will have to continue to adopt a flexible approach to day-to-day operations--within the constraints adopted by the Committee--until there has been a full adjustment by the banking system to the recent regulatory changes.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 17 through November 20, 1972, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement on the monetary relationships discussed in the blue book:

Following the discussion of the chart show and policy procedures yesterday, I will be quite brief today. The policy alternatives posed for Committee consideration are essentially the same as they were at the last meeting. In terms of monetary aggregates, they revolve around growth rates indexed by M_1 expansion at annual rates of 5, 6, and 7 per cent.

The principal difference in the staff's assessment of the near-term outlook is that we foresee less upward interest rate pressures for any given expansion in the aggregates. This is partly because the recent persistence of growth rates below expectations has led us to mark down somewhat our estimate of the strength of the current underlying demand for money and liquidity. This may be a temporary phenomenon, but it also could be that money demand will remain on the low side in relation to GNP growth following the substantial build-up of cash balances and liquid asset holdings over the past few years.

Market attitudes toward interest rates also appear to have become more favorable in the past few weeks, for reasons noted in the material circulated to the Committee. One of the reasons has been the moderate behavior of the aggregates, which has come to be associated with a market view that the Federal Reserve may not have to tighten up as much as earlier anticipated. But I would still think that short-term interest rates are likely to show at least some seasonal rise between now and mid-December. However, the favorable psychological atmosphere and the comparatively light volume of new corporate and municipal bond offerings in prospect will tend to keep seasonal short-term rate increases from being communicated in a significant way to long-term markets.

Advantage might be taken of the calmness of credit markets and the apparent moderation of money demands in shaping policy strategy for the next few weeks. For instance, the Committee may again wish to skew ranges of tolerance for growth in the aggregates in a downward direction.

With economic activity vigorous, we still anticipate some short-run bulge in demand for money and RPD's, caused in part by a projected sharp December drop in U.S. Treasury deposits. Thus, at prevailing money market conditions, we would project November-December growth rates for M_1 and RPD's of just under 7 per cent and 9 per cent, respectively. But given the strength of the aggregates in the third quarter and the prospective strength of GNP, the Committee may wish to consider such growth rates as near the top of its short-run ranges of tolerance. In that case, the November-December ranges shown for alternative C in the blue book, including 6 to 10 per cent for RPD's and 4 to 7 per cent for M_1, could be taken as representing ranges that lean more toward accepting shortfalls than overshoots.

The Committee may nevertheless wish to constrain the funds rate to a range more like that shown under alternative B--4-3/4 to 5-1/2 per cent. We believe that such a constraint would still be consistent with a longer-run M_1 growth rate of 6 per cent in any event, and would run only a moderate risk of eroding the favorable market atmosphere in the forthcoming period of seasonal short-term credit demands. At the same time, the skewed range of tolerance for M_1 and RPD's in November-December would permit the Committee to take advantage of any slower short-run expansion in demand for reserves, should it develop, to make some headway toward a slower longer-run average growth rate in the aggregates.

Mr. MacLaury asked Mr. Axilrod to explain the rationale underlying certain variations in the ranges given for particular variables in the blue book specifications for the November-December period. First, under all three policy alternatives a range of 4 percentage points was shown in connection with the growth rate in RPD's, but the ranges for the growth rates in M_1 and M_2 were only 3 points wide. Secondly, for the Federal funds rate the range was 1 point wide under alternatives A and C but only 3/4 of a point w[illegible] alternative B.

In reply, Mr. Axilrod noted that RPD's were primarily an operating handle, and that some slippage could be expected because of unanticipated shifts in the multiplier relationship between reserves and deposits. A slightly wider range was given for RPD's than for the monetary aggregates in order to leave room for such slippage. With respect to the Federal funds rate, the ranges shown under all three alternatives encompassed the existing rate. Since the funds rate was expected to decline under alternative A and to rise under C, wider ranges were indicated in connection with those alternatives than in connection with alternative B, under which little change in money market conditions was anticipated.

Mr. Heflin noted that, according to the blue book, the slower-than-anticipated growth in M_1 over the October-November period might be explained in part by the higher-than-anticipated level of Government deposits in November. He asked whether part of the explanation might not also be found in a lagged reaction of money demands to the increases in short-term interest rates that occurred in August and September.

Mr. Axilrod replied that the earlier estimates of growth in M_1 during October and November had included an allowance for the effects of the late-summer rise in short-term rates. The size of the allowance reflected historical relationships and it might well have been inadequate. Another possibility was that rising incomes were now exerting less of a pull on money demands than would be expected on the basis of past relationships. He was not sure which hypothesis was the more likely.

In reply to a further question by Mr. Heflin, Mr. Axilrod said the staff still expected some increase in transactions demands for money in November and December as a result of the strong fourth-quarter rise in GNP. Also, a sharp drop in Government deposits in December was expected to make a transitory contribution to the rise in private demand deposits in that month.

Mr. Eastburn observed that unexpected changes in the monetary aggregates were often explained after the fact in terms of shifts in the demand for money. He wondered whether any studies were being made to develop a better understanding of money demand.

Mr. Axilrod replied that such studies were made continually, in the sense that the staff periodically reestimated the money demand equations in its various econometric models. While each revision in those equations reflected the changes in underlying relationships since the previous revision, it would probably never be possible to "catch up" since further changes in the public's behavior and attitudes toward money could always be expected. In addition, the demand deposit ownership surveys that had been made recently threw some light on current developments. Such surveys had their limitations at best, and the fact that they were as yet available for only a brief period made it even more difficult to interpret them properly. Nevertheless, it was interesting to note that in the third quarter--when the money supply was growing rapidly on average--the survey indicated that there had been a large increase in deposits of nonfinancial corporations. Such a development might be expected in a period of rapidly growing business activity, and also at a time when banks might be increasing their compensating balance requirements in connection with efforts to tighten lending terms. In that sense the survey suggested that there had been an increase in the demand for money at given levels of interest rates.

Mr. Daane noted that it was proposed in all three alternatives for the operational paragraph of the directive[1/] to delete the

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

references contained in the present directive to both Treasury financing operations and developments in credit markets. As he understood it, the reasoning was that the Treasury financing operations in prospect at the moment were not of a kind to call for even keel considerations, and that the climate in credit markets was now sufficiently favorable to make unnecessary any special mention of such markets in the directive. He wondered, however, whether it might not be desirable to retain some glancing references of those kinds, since the nature of Treasury operations during the coming period was still uncertain and since one could not be sure that the recent calm in credit markets would continue.

Mr. Axilrod said he thought there was a risk that such references would be misinterpreted, given the nature of prevailing circumstances. For example, the only Treasury financing operations now definitely scheduled before mid-December involved auctions of tax-anticipation bills, which normally would not require even-keel treatment. If the Treasury should decide to auction a long-term bond during the period, the issue was likely to be a small one and the Desk could take the operation into account in the normal course of operations, without special instructions in the directive.

Mr. Hayes remarked that he would prefer to omit the references in question since the arguments in their favor were much weaker today than when they had originally been added to the directive. It was possible, of course, that the situation might change during the period. However, such uncertainties almost always existed, and the references would tend to lose force if they were routinely included in the directive on such slight grounds.

Mr. Holmes said he was inclined to agree that the references to Treasury financing and credit market conditions could be eliminated from the directive on the basis of what was known now. He added that if the Treasury should decide to issue a long-term bond during the period the Desk would endeavor not to upset the operation, taking it for granted that that was the Committee's preference. Similarly, if credit market conditions took a turn for the worse--perhaps because of some bad news--the Desk would take that development into account.

Mr. Daane remarked that he would be agreeable to the elimination of the references so long as it was understood that the Desk would operate in the manner Mr. Holmes had outlined.

Chairman Burns then suggested that the Committee discuss its targets for the monetary aggregates over the longer run--for the fourth and first quarters combined--keeping in mind that any decision reached today would be subject to review and revision at each subsequent meeting.

Mr. Hayes said he might first list some of the considerations he thought the Committee should keep in mind in considering targets for policy. The economy was moving up strongly, and credit demands were likely to grow appreciably over coming months; inflationary expectations were somewhat dampened, but by no means dead; there were major uncertainties as to what lay ahead in the way of fiscal policy and the wage-price control program; and the dollar's strength at the moment in foreign exchange markets was still highly tentative, especially in light of rising interest rates abroad.

Those considerations suggested to Mr. Hayes that the Committee had to remain very much on the alert, and that when it next moved the move should be in a firming direction. On the other hand, recent developments in the course of the aggregates and in financial markets offered reason to pause before considering such a move. Moreover, it would be easier to form a judgment a little later, when better clues were available as to the prospects for wage-price controls and the outlook for the Federal budget. At the moment, he would lean toward 6-month targets for the aggregates indexed by an M_1 growth rate in the area of 5 or 5-1/2 per cent rather than 6 per cent.

Mr. Francis observed that he liked very much the approach the Committee was following today of focusing first on longer-range objectives for the monetary aggregates. He hoped that operations would be conducted in a manner that yielded an M_1 growth rate in the vicinity of 5 per cent over the fourth and first quarters combined. He was somewhat concerned about the magnitude of recent short-run fluctuations in the M_1 growth rate, and he recognized that M_1 might have to grow at a rate above 5 per cent for a time to offset the lower rate recorded in October.

Mr. Mayo remarked that if the choice of longer-run targets were limited to the three alternatives shown in the blue book he would choose alternative B, calling for growth rates of 6 and 8 per cent for M_1 and M_2, respectively. Such growth rates would correspond roughly to recent experience and would seem consistent with the economic trends anticipated by the staff in its presentation yesterday. However, if he were to lean toward either alternative A or alternative C, he would be inclined to lean gently in the direction of the more restrictive course outlined under C.

Mr. Brimmer said he would prefer delaying a shift toward lower long-run targets for the monetary aggregates. A reduction to target growth rates symbolized by a 5 or 5-1/2 per cent rate for M_1 might be appropriate at the December or January meeting. For the time being, however, he would prefer to táck and trim a bit, in an effort to make some further progress in reducing the margins of unutilized resources and while awaiting a better indication of the prospects for wage and price controls. Accordingly, his current preference for a longer-run target would be a 6 per cent M_1 growth rate.

Mr. Morris said he also would consider 6 per cent to be the appropriate longer-run target growth rate for M_1. In his judgment it would be premature to aim for a lower growth rate at this stage of the cycle, given the existing amount of slack in the economy and the staff projection that the unemployment rate would still be in the neighborhood of 5 per cent in the fourth quarter of 1973. At the same time, since he was not persuaded that the recent relative weakness in the demand for money would persist for very long, he thought the difficulty of holding the money growth rate down to 6 per cent was likely to increase over coming months. Accordingly, he would be happy to see M_1 grow at a rate below 6 per cent for the next month or two.

Mr. Heflin said his views were similar to those just expressed by Mr. Morris, including the preference for a longer-run growth rate in M_1 of about 6 per cent. He added that the Committee might feel less reluctance to let upward pressures on short-term rates show through in the first quarter, particularly if an increase in the discount rate appeared desirable at that time.

Mr. Kimbrel observed that he had been impressed by the attitudes towards wage and price controls that had been evident in recent meetings he had held with groups of businessmen in Atlanta and Birmingham. While virtually all of those businessmen were able to cite instances in which the controls had produced difficulties for them or had led to inequities, they were almost unanimous in their hope that the program would not be permitted to lapse now or, indeed, at any time in 1973. In general, they expected greater upward pressure on prices than suggested by the projections the staff had presented yesterday, and they were concerned about the risks of a new wave of inflationary expectations. While those attitudes were not founded on highly sophisticated economic analyses, he thought they warranted some attention by the Committee since they would influence the businessmen's decisions on investment and other business policies. Against that background, he would favor a longer-run target growth rate for M_1 of 6 per cent, and he would not be unhappy if it proved possible to achieve a growth rate closer to 5 per cent.

Mr. Bucher observed that there was a way of reasoning, known as the "school of contrary opinion," which was often employed by people in the securities business when a pattern of unanimity appeared to be developing among market participants. To illustrate, a general tendency by investors in odd-lot securities to go short on the market would be interpreted by members of the school as a bullish signal, on the grounds that any opinion widely shared among odd-lot investors was almost certain to be wrong. At the moment he thought something approaching a herd instinct was reflected in the tendency of economists to project strongly rising activity. While he would not suggest that economists should be classed with odd-lot investors, he had been tempted to apply the teachings of the contrary-opinion school to the extent of searching for gaps in their analyses.

However, Mr. Bucher continued, he had found that rather difficult to do on the basis of the facts available to him. It was true that unemployment was still at a level that many people would find unacceptable. Moreover, the staff projections suggested that the capacity utilization rate in the current quarter would average only 79 per cent. Against such considerations, there were a number which would incline him to follow the herd today. For one thing, even if wage-price controls were continued in some form, he thought they could not be expected to be effective over a long period; by their nature, such programs could be relied on only temporarily. Secondly, he suspected that consumers would spend a larger proportion of their tax refunds early next year than assumed in the staff's projections. Finally, while he knew the Administration would make a strong effort to hold down Federal expenditures and he hoped it would succeed, he was not optimistic on that score in light of the problems that Congress had in exercising discipline over the budget.

Accordingly, Mr. Bucher said, if he were to formulate his policy views in sailboating terminology, as Mr. Brimmer had, he would call for turning the winch slightly. Translating that into a longer-run target for growth in M_1, he would favor aiming for a rate slightly under 6 per cent.

Mr. Robertson said he concurred in general with Mr. Bucher's views. On the basis of the recent behavior of the monetary aggregates and, more generally, of the economy, it could be argued that the Committee had been performing its task reasonably well and should continue on its present course over the next 6 months. He did not accept that argument, however, because he believed that much of the Committee's recent success was attributable to the existence of wage-price controls which could not be relied on indefinitely. And like Mr. Bucher he believed that effective control of Federal expenditures was more of a hope than a firm expectation. Consequently, looking ahead to the next 6 to 12 months, he thought there were greater risks of inflation than of insufficient expansion to reduce unemployment to the extent desired.

In his judgment, Mr. Robertson continued, the Committee would have to improve its performance in order to speed the day on which controls could be eliminated. The better the job done with respect to both monetary and fiscal policy, the closer that day would be. While he could not say what precise growth rate in M_1 would be appropriate for the next 6 months, he would be inclined to snug up a bit and aim for a rate somewhat below 6 per cent.

Mr. Sheehan remarked that in nautical terms his own policy prescription would be "steady as you go." He noted that the staff's latest projections were the first in which a continuation of the wage-price control program had been assumed. He gathered that the Administration intended to propose to Congress that the program be continued; personally, he hoped it would be retained, essentially in its present form, throughout 1973. He had been quite pleased to learn from the reports of Messrs. Daane and Brimmer today that the degree to which this country had brought inflation under control was clearly recognized in Europe. The job was not yet done; but if the progress made over the past year could be repeated in the coming year, the nation would have accomplished something unique and remarkable.

In his judgment, Mr. Sheehan continued, the key to substantial further progress against inflation lay in the attitude of organized labor in the coming pay negotiations. He hoped the Pay Board would find it possible to reduce the wage guideline by as much as a full percentage point, but at a minimum it was essential that the unions agree to increases no larger than those negotiated during the past year. Before they would agree, however, they would have to be persuaded that living costs were not rising; and from the Committee's point of view, the significant fact was that the unions included interest rates among the costs with which they were concerned. Union leaders were very much aware of changes in the prime rate and could be expected to keep their members informed of any increases. That fact had been of deep concern to him in thinking about policy over the past 6 months. In his view, a "snugging up" of policy might serve the anti-inflation objective in a narrow sense, but if it resulted in sufficiently large increases in interest rates to affect the attitudes of unions it could well be a net disservice to that objective.

Mr. Daane observed that it was necessary for a sailor to identify his objective on shore correctly if he was to be successful in tacking toward it. He was disturbed by today's discussion of longer-run objectives for monetary policy because it was formulated in terms of desired growth rates of the monetary aggregates; to his mind, the Committee's real objective for the next 6 months was to bring about a reduction in the rate of inflation. He doubted that anyone could assert with confidence at this point that that objective required a 5 or a 6 per cent rate of growth in M_1. If the Administration were successful in achieving the degree of fiscal restraint it apparently was seeking, he would not be surprised to find that an abatement of inflationary pressures was consistent with an M_1 growth rate of 6 per cent or even higher. It might also prove to be consistent with a continuation of money market conditions similar to those prevailing now. But he thought the objective itself should be formulated in terms of a slower rate of increase in average prices. He hoped that objective could be attained with relatively little rise in interest rates, and he would be willing to accept any resulting growth rate in M_1 that fell within a relatively broad range--say, from 2 to 10 per cent.

Mr. Balles said he hoped that as a newcomer to the group he would be permitted for a time to raise questions rather than state positions. He might allude first to the bullish character of the staff's projections and to Mr. Partee's concluding comment that, if anything, the projections were conservative since consumer spending, business capital spending, and inventory investment might all rise more than anticipated and residential construction might decline less. Secondly, he would allude to a question asked by Mr. Mitchell yesterday which, he believed had remained unanswered, concerning the combination of monetary and fiscal policies that might bring the rate of inflation down to 3 per cent. With those two matters as background, he would simply state that he was concerned about the lags in the effects of changes in monetary policy on the real economy. According to his recollection, those lags had not been mentioned at the previous meeting nor thus far in this one; perhaps the Committee had long since laid aside the questions relating to lags as unanswerable.

Taken together, Mr. Balles continued, such considerations led him to the conclusion that, if the current rate of monetary growth was appropriate now, a somewhat slower rate would be appropriate in the coming year. In reaching that conclusion he was assuming that the staff was right--and they probably were--in projecting a renewed rise in unit labor costs and stronger upward pressures on prices than during the past year.

Mr. MacLaury noted that a number of speakers had implied that they did not attach much significance to the difference between the 6 per cent growth rate in M_1 associated with alternative B and the 5 per cent rate of alternative C as longer-run targets for policy. Personally, he believed that the choice between those growth rates was much less important than the question of how determined the Committee would prove to be in achieving whatever rate it selected as its target. He considered the latter question to be of particular importance because, like Mr. Morris, he thought it would become increasingly difficult to keep M_1 from growing at faster rates as time passed.

Mr. MacLaury observed that he would favor the alternative B target of 6 per cent for M_1 growth over the fourth and first quarters combined. But whatever the target chosen by the Committee, he hoped it would hold to it--taking account of the growth rates actually experienced as the period unfolded in deciding on appropriate rates for the remaining part of the period--so long as the outlook for the real economy remained unchanged. The target growth rate should, of course, be reconsidered if there was some significant change in the economic outlook.

Mr. Brimmer said he would like to comment on some of the observations made by other speakers after he had stated his own preferences with respect to longer-run objectives. First, he noted that Mr. Robertson had suggested that the Committee should seek to speed the day on which it would be possible to eliminate the present controls on wages and prices. The question in his mind concerned the price the Committee should be willing to pay--in terms of unutilized capacity and unemployment--simply for the sake of ending the controls. He personally hoped that the controls would be kept in place as long as necessary in the effort to reduce the rate of price advance to acceptable levels. And he hoped the Committee would be prepared to tolerate a slightly higher rate of inflation than otherwise so long as there was a significant volume of unutilized resources. In that connection, it was worth noting that a reduction in the growth rate of M_1 from 7 to 5 per cent, according to the staff's projections, would have a rather small effect on the rate of price advance in the period covered by the projections.

Secondly, Mr. Brimmer continued, if he understood Mr. Sheehan correctly the latter thought the Committee's overriding concern should be the avoidance of a significant rise in interest rates. In his (Mr. Brimmer's) judgment interest rates should be only one of many considerations taken into account. Looking ahead, he suspected that it would not be very long before a reduction in the Committee's target growth rate for M_1 would appear desirable, and that move no doubt would be associated with some rise in market rates. Perhaps the Committee should be prepared at that point to pay some price in terms of a higher M_1 growth rate in order, say, to keep the prime rate from moving above 6 per cent. He hoped, however, that the members would weigh the alternatives carefully, since the cost of holding interest rates down was likely to be a faster rate of inflation.

Mr. Sheehan remarked that the cost of letting interest rates rise significantly might well be the sacrifice of the Government's whole anti-inflationary program. As he had indicated, the success of that program was likely to depend directly on whether the unions would agree to moderate wage increases in the coming negotiations. In formulating their views union leaders would be considering the rate of increase in prices and the rate at which dividends were being paid. They also would be giving considerable weight to interest rates, however, and in his judgment a rise in the prime rate to levels above 6 per cent could have a significant effect on their attitudes.

Mr. Brimmer said he might remind the Committee of its unpleasant experience with pegged interest rates in the period following World War II.

Chairman Burns observed that he had not interpreted Mr. Sheehan's policy prescription as calling for pegged interest rates.

Mr. Eastburn remarked that he had received the impression during a luncheon discussion yesterday that Chairman Burns believed there was no necessary conflict between System open market policy and the policies with respect to interest rates pursued by the Committee on Interest and Dividends. However, some of the discussion today suggested that there might indeed be a conflict.

Chairman Burns said he could state his position on that question in the following way. As long as the FOMC formulated its objectives in terms of reserves and the monetary aggregates, he believed it could make its decisions effective despite the activities of the Committee on Interest and Dividends. That Committee clearly recognized that it would be undesirable to attempt to control market interest rates, but it had already taken some informal action with regard to the prime rate and it might take further actions in the area of administered interest rates. Assuming, for illustrative purposes, that it went to the extreme of freezing administered rates completely, banks would simply rely entirely on nonprice means for rationing credit rather than--as at present--use both price and nonprice rationing.

On the other hand, the Chairman continued, if the FOMC were to formulate its objectives in terms of interest rates, a conflict with the Administration could quickly develop. From that point of view it was fortunate that the FOMC was following an aggregate approach, although he recognized that Mr. Daane was unhappy with that approach on other grounds. At present, he believed that the only consequence for System policy flowing from the work of the Committee on Interest and Dividends was that changes in the discount rate probably would have to lag changes in market rates by a little more than they otherwise would.

Chairman Burns added that he hoped the Committee on Interest and Dividends would not find it necessary to take further action with respect to interest rates. In general, he was of two minds about the whole structure of controls. In view of the problem of inflation, he thought it would be useful to keep the wage and price controls in place for another year; he doubted that their remaining effective life would be longer than a year but he would not want to shorten it. With respect to the area covered by the Committee on Interest and Dividends, he would prefer to see controls formally ended or permitted to lapse. The political situation, however, would probably make this impossible.

The Chairman then said it would be helpful to know whether the staff agreed that a freeze on administered interest rates would not prevent the FOMC from achieving its objectives with respect to the aggregates.

Mr. Partee said he did agree with that view, so long as the freeze applied only to administered rates. A freeze on market rates probably could not be made effective unless the System were willing to supply whatever volume of reserves was necessary for the purpose.

Mr. Daane said he would like to make it clear that he did not advocate setting longer-run targets in terms of interest rates. What disturbed him about aggregate targets was the kind of argument that had been made by Mr. Zjilstra last week in his address during the ceremonies marking the 50th anniversary of the Austrian National Bank. Specifically, Mr. Zjilstra had suggested that the problems of inflation and deflation could be eliminated by insuring that the money supply, narrowly defined, grew at the same rate as real GNP. He (Mr. Daane) did not accept that argument.

Chairman Burns concurred in Mr. Daane's view.

Mr. Eastburn observed that if the Committee were to adopt a 6 per cent growth rate as its target for M_1 over the fourth and first quarters it probably would have to expect market interest rates to rise. A willingness to permit interest rate increases would be essential for the sake of a flexible open market policy.

Mr. Hayes said he recognized the force of the comments by Mr. Sheehan and others with respect to the risks for the wage-price control program that would be involved in a rise in market interest rates. Personally, however, he believed that such riskswould have to be accepted. If the Committee sacrificed its objectives for the aggregates because achieving them could entail a substantial rise in interest rates, it might find itself winning the battle with respect to the wage-price controls program and losing the war against inflation. It was quite possible--although by no means certain--that the Committee would have to face such a choice in the coming 6 months; if it did, he would want to maintain monetary control.

Chairman Burns said he could summarize the Committee's views on longer-run targets for the monetary aggregates in the following way: for the present the Committee favored growth represented by an annual rate of approximately 6 per cent in M_1; in addition, there was some sentiment among the members that a lower rate would become desirable at some time in the future.

The Chairman then proposed that the Committee hold a brief go-around, beginning with Mr. Hayes, on language for the operational paragraph of the directive and on short-run operating specifications.

Mr. Hayes said he favored maintaining the Federal funds rate near its recent level of 5 to 5-1/4 per cent at this time. In order to allow for contingencies and to give the Manager needed flexibility, he would specify a permissible range for the funds rate of 4-3/4 to 5-1/2 per cent--the range that had obtained for the past month and the one shown under alternative B in the blue book. However, he preferred the directive language of alternative C and the specifications shown under that alternative for growth in the aggregates over the November-December period, including the 4 to 7 per cent range specified for M_1. Although a 5 to 6 per cent funds rate range was shown under alternative C in the blue book, the New York Bank's projections suggested that the lower range which he preferred would prove consistent with the alternative C growth rates for the aggregates. He hoped the Bank's projections would prove correct.

Continuing, Mr. Hayes noted that last week the directors of the New York Bank had voted to reestablish the existing discount rate because they felt that circumstances were less pressing for an increase now than they had been 6 or 8 weeks ago. He agreed with that judgment; the same factors that supported a no-change open market policy also pointed to the desirability of holding to the existing 4-1/2 per cent discount rate for the time being. Although he would prefer to see a smaller spread between the discount rate and market rates, the existing spread had not as yet caused any problems at the discount window.

Mr. Hayes added that the high level of stock market credit, together with the recent surge in stock prices, suggested to him that the Board might wish to consider an increase in margin requirements.

Chairman Burns commented that the Board's staff was keeping a close watch on the stock market and the Board itself would be discussing developments in that area.

Mr. Francis said he favored the language of alternative C. Although he also favored the longer-run targets of alternative C, he thought they would be compatible with the short-run operating specifications of alternative B.

Mr. Kimbrel said he preferred the short-run specifications of alternative B, and he thought that any deviations should be in the direction of alternative C.

Mr. Eastburn observed that he too preferred the specifications of alternative B. With respect to the Federal funds rate, he believed that the specified range should be meaningful; the rate should be allowed to go to the indicated upper limit of 5-1/2 per cent if that became necessary to achieve the Committee's objectives for the aggregates.

Mr. Winn remarked that he preferred alternative B.

Mr. Bucher said he favored the range for the funds rate specified in alternative B. He could accept the growth rates for the aggregates of alternative B, but he would prefer any deviation from those rates to be in the direction of alternative C.

Mr. Sheehan said he preferred alternative B.

Mr. Brimmer observed that he too favored alternative B.

Mr. Daane said he preferred the language of alternative B and the money market conditions associated with that alternative. He would not be unhappy if the aggregate growth rates of alternative C were realized, but he would note for the record that he believed too much emphasis was being placed on the aggregates.

Mr. Mitchell said he much preferred the language of alternative B to that of C, which he regarded as ambiguous. However, since he would like to see the growth rate of M_1 edge down, he favored the specifications of alternative C except for the Federal funds rate; for the latter he would prefer a range of 4-3/4 to 5-3/4 per cent to either the 4-3/4 to 5-1/2 per cent range of B or the 5 to 6 per cent range of C. He did not see any good reason for establishing a separate constraint on the rate of growth in M_2; indeed, rapid growth in the component of M_2 not included in M_1 might well contribute to the achievement of the Committee's objectives.

Mr. Heflin said he favored alternative B.

Mr. Clay observed that he preferred alternative B, and he hoped that any deviations would be in the direction of C.

Mr. Mayo said he preferred the short-run operating specifications of alternative B with two modifications. First, he would shift the M_1 range down from 5 to 8 per cent to 4-1/2 to 7-1/2 per cent, making it symmetrical with respect to the longer-run target. Secondly, like Mr. Mitchell he would widen the funds rate range to 4-3/4 to 5-3/4 per cent; a range of one percentage point was desirable to provide the Manager with sufficient flexibility. Unlike Mr. Mitchell, he preferred the language of alternative C to that of B. The difficulty with the latter was that it called for more moderate growth in monetary aggregates "than recorded in the third quarter." To his mind the third quarter was not a proper benchmark. The latest 3 months--August through October--would be better, but in that period M_1 grew at an average rate below the longer-run target rate of 6 per cent.

Mr. MacLaury remarked that he preferred the short-run specifications for the aggregates of alternative C, partly because the midpoint of the range shown for M_1--4 to 7 per cent--was below the longer-run target growth rate of 6 per cent, whereas the midpoint of the 5 to 8 per cent range of B was above 6 per cent.

For the Federal funds rate he favored the alternative B range. Like Mr. Eastburn, he believed that the funds rate should be allowed to move to the upper limit of its range if that became necessary.

Mr. Balles observed that he favored specifications similar to those of alternative B, but leaning in the direction of alternative C. With respect to directive language, he hoped that a replacement could soon be found for the word "moderate."

Mr. Plant remarked that, after discussing the substance of the staff presentation on the economic outlook with Mr. Coldwell, who was absent today, he would advocate short-run specifications between those of alternatives B and C, but leaning toward those of C. Such specifications would be consistent with longer-run targets represented by a 5-1/2 per cent growth rate of M_1. For the funds rate he favored a range of 4-7/8 to 5-3/4 per cent.

Mr. Morris said he supported the specifications of alternative B, except that he preferred a 5 to 5-1/2 per cent range for the funds rate to the 4-3/4 to 5-1/2 per cent range shown under that alternative in the blue book. As a matter of short-run operating strategy he would not want the Desk to press the funds rate down to 4-3/4 per cent if the aggregates appeared to be growing at less than expected rates in the coming period.

Mr. Mitchell remarked that he also would not want the Desk to seek a lower funds rate in the period immediately ahead if the aggregates appeared to be weaker than expected. In expressing a preference for the specifications of alternative C he had been interpreting the aggregate growth rates shown under that alternative as representing the staff's judgment of the most restrictive policy course that lay within the limits of reasonableness at this time. He believed, however, that no harm would be done if the aggregates grew at low rates for a month or so, and that no action to stimulate their growth should be taken by the Desk.

Mr. Daane said he had not thought the Committee would want the Manager to move aggressively to ease money market conditions in the coming period if there was a shortfall from expectations for the aggregates.

After further discussion, Chairman Burns commented that under current procedures the Manager would be expected to let the funds rate move toward the lower limit of the range of tolerance specified should the aggregates appear to be growing at rates below those the Committee had indicated it desired. If the members agreed with Mr. Morris that some shortfall from the alternative B growth rates in the coming period should not result in a decline in the funds rate to 4-3/4 per cent, it could follow

Mr. Morris' suggestion and set the lower limit for that rate of 5 per cent. However, he thought there was a better way of achieving the same objective--by retaining the alternative B range for the funds rate but lowering the ranges of tolerance for the growth rates of the monetary aggregates, or perhaps reducing only the lower limits of those ranges.

The go-around was then concluded with comments by Mr. Robertson, who indicated that he would not want the aggregates to expand at rates higher than those of alternative B and that he did not consider the alternative C rates to be too low. He added that he favored the money market conditions shown under alternative B.

Chairman Burns then said that in deliberating on the problem before the meeting he had found himself inclined toward the directive language, longer-run targets, and Federal funds rate constraint of alternative B; and toward the ranges for November-December growth rates in the aggregates specified under alternative C. The go-around could be interpreted as indicating that a majority of members preferred the aggregate growth rates of alternative B. However, after taking account of the various qualifying comments that had been made, he believed that the views of most members were quite close to his own. He proposed that the Committee vote on a directive consisting of the staff's draft of the three general paragraphs and alternative B of the operational paragraph, on the understanding that the directive would be interpreted in the manner he had described.

Mr. Holland noted that, with respect to longer-run targets, the Chairman's proposal involved the following annual rates of growth over the fourth and first quarters combined, to be subject to review and revision at each subsequent meeting: M_1, 6 per cent; M_2, 8 per cent; bank credit proxy, 6-1/2 per cent; and RPD's, 6-1/2 per cent. With respect to short-run operating constraints, the proposal involved the following ranges of tolerance for the annual rate of growth over the November-December period: RPD's, 6 to 10 per cent; M_1, 4 to 7 per cent; and M_2, 5 to 8 per cent. Finally, the range of tolerance in the daily-average Federal funds rate for statement weeks in the period until the next meeting would be 4-3/4 to 5-1/2 per cent.

By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions for the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting, including recent data for industrial production, employment, and retail sales, suggests that real output of goods and services is growing more rapidly in the current quarter than in the third quarter. However, the unemployment rate has remained substantial. The increase in wages has been larger in recent months than earlier this year.

Consumer prices rose considerably in September, but the October rise in wholesale prices was small. In recent weeks, the current account deficit of the U.S. balance of payments has been offset in large part by capital inflows; while the reserves of Japan have increased substantially further, those of other industrial countries have changed little. In September the excess of U.S. merchandise imports over exports remained large.

In October rates of growth in the monetary aggregates changed relatively little from preceding months, with expansion in the narrowly defined money stock again quite moderate. Since mid-October interest rates generally have declined.

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

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

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

Chairman Burns noted that a memorandum from the System Account Manager, entitled "Semi-annual Review of System Lending Operations," had been distributed on October 12, 1972, along with a related memorandum from the Committee's General Counsel.1/ He asked Mr. Holmes to comment.

1/ Copies of these memoranda have been placed in the Committee's file.

Mr. Holmes observed that he had little to add to his memorandum. While further progress had been made since last March in moving to a book-entry system for Government securities, delivery failures still remained a problem for the market. System lending of securities--particularly in light of the general shortage of free collateral in the market--continued to contribute to the effective functioning of the Government securities market and so facilitated the conduct of System open market operations. There had been no operational problems in conducting lending operations and no abuse of the privilege,insofar as he knew. The facility had been used to a limited extent by banks participating in the automated Treasury security clearing arrangement, thus contributing to the effective functioning of that important device to reduce the physical handling and storage of securities.

On the basis of experience since March, Mr. Holmes said, he recommended that the Committee find that the lending of securities continued to be reasonably necessary for the conduct of open market operations and that the continuing authority directive relating to the lending of securities should remain in effect, subject to a semi-annual review.

Mr. Holmes added that a request had been received from the Association of Primary Dealers in Government Securities that System lending of securities be broadened so as to permit loans of securities to cover short sales by dealers under certain restricted conditions.

Memoranda were being prepared by the Board staff and at the Desk and should be distributed shortly, with the expectation that the dealer request would be placed on the agenda of a subsequent meeting of the Committee.

Mr. Robertson asked how the volume of lending in, say, the past 2 months compared with the volume of 6 months ago.

Mr. Holmes replied that the recent volume was slightly higher on average than it had been 6 months earlier. However, the difference was not very great.

Mr. Brimmer asked how the importance of System lending operations relative to the total volume of market transactions had changed in recent years.

Mr. Axilrod replied that one useful measure was the percentage of total market trading represented by the sum of delivery failures plus System security loans, since each loan could be assumed to have forestalled a failure of equivalent size. That percentage had declined from the neighborhood of 15 per cent in 1969, when the System first undertook lending operations, to a 7 to 10 per cent range in subsequent years. Recently there had been no significant reduction.

Mr. Brimmer remarked that those figures tended to confirm his concern that System lending operations might become a permanent institution. He hoped some means could be found for eliminating the need for such operations.

Mr. Holmes noted that since 1969 there had been a decline in the volume of Government securities available for lending from private sources, which accounted in part for the continuing need for lending by the System.

In response to a question by Chairman Burns, Mr. Hackley said there was no provision of law that expressly authorized the Reserve Banks to lend Government securities, and that any such authority had to be derived from the statutory authority of the Reserve Banks to exercise "such incidental powers as shall be necessary to carry on the business of banking within the limitations prescribed" by the Federal Reserve Act. Accordingly, as he had noted in his memorandum, the statutory authority depended on the factual question whether the activity was reasonably necessary to the effective conduct of open market operations.

The Chairman then asked Mr. Holmes first, whether there was any financial risk to the System in lending operations and secondly, what the consequences might be of a discontinuation of such operations.

Mr. Holmes replied that there was no risk exposure in lending, since all System loans of securities were covered by collateral in the form of other securities of greater value. Lending operations had played an important role in reducing the problem of delivery failures in the Government securities market, and to discontinue them would, in his judgment, be to eliminate a type of activity that had been highly useful to the System in the conduct of open market operations.

Mr. Daane noted that the System had a great interest in the effective functioning of the market in which it conducted its open market operations, and indicated that he shared the Manager's view that such lending was reasonably necessary to the effective conduct of operations.

Chairman Burns expressed the hope that the Manager would be able to report at the time of the next semi-annual review that lending of Government securities was no longer reasonably necessary. He then asked whether there was any objection to continuing the authority for lending operations at this time, and none was heard.

> It was agreed that the authorization for the lending of Government securities from the System Open Market Account should be retained at this time.

Mr. Daane then observed that the proceedings at this meeting lent support to his view, which he had expressed on earlier occasions, that the Committee's deliberations on policy were facilitated when a meeting was held over a 2-day interval. By devoting Monday afternoon to its discussion of the economic situation and outlook, the Committee eliminated the pressure of time on Tuesday morning and could proceed with its policy deliberations in a more relaxed--and therefore more fruitful--fashion.

In the subsequent discussion it was noted that Presidents from the more distant Reserve Banks customarily arrived in Washington a day early when Committee meetings were scheduled to begin on Monday afternoon. At the conclusion of the discussion Chairman Burns noted that the Committee had been experimenting with occasional 2-day meetings, usually at times when the staff had prepared a chart presentation on the outlook. The Committee might want to reduce or increase the frequency of such extended meetings in the future; for the time being, however, he suggested that the matter be left open.

The Chairman then noted that he had commented at the beginning of yesterday's session on a proposal that the Board establish a staff committee with responsibility for reviewing System discount operations and for promoting uniform discount window administration. He understood that some questions had been raised subsequently about the role of such a committee. He thought it would be best to defer action on the proposal until there had been an opportunity for further discussion between the staffs of the Board and the Reserve Banks and between the Governors and the Presidents.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, December 19, 1972, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

November 20, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 20-21, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting, including recent data for industrial production, employment, and retail sales, suggests that real output of goods and services is growing more rapidly in the current quarter than in the third quarter. However, the unemployment rate has remained substantial. The increase in wages has been larger in recent months than earlier this year. Consumer prices rose considerably in September, but the October rise in wholesale prices was small. In recent weeks, the current account deficit of the U.S. balance of payments has been offset in large part by capital inflows; while the reserves of Japan have increased substantially further, those of other industrial countries have changed little. In September the excess of U.S. merchandise imports over exports remained large.

In October rates of growth in the monetary aggregates changed relatively little from preceding months, with expansion in the narrowly defined money stock again quite moderate. Since mid-October interest rates generally have declined.

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

OPERATIONAL PARAGRAPHS

Alternative A

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

Alternative B

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

Alternative C

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

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

November 21, 1972

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 11/21/72)
A. Longer-run targets (SAAR): (first and fourth quarters combined)	M_1	6%
	M_2	8%
	Proxy	6-1/2%
	RPD's	6-1/2%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (November-December average):		6-10%
2. Ranges of tolerance for monetary aggregates (November-December average):	M_1	4-7%
	M_2	5-8%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		4-3/4 - 5-1/2%
4. Federal funds rate to be moved in an orderly way within range of toleration		

5. Other considerations: account to be taken of effects of recent bank regulatory changes.

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

ATTACHMENT C

Office Correspondence

Date November 20, 1972

To Board of Governors

From Governors Mitchell and Daane

Subject: Foreign Banks in the United States

The assignment given to us was to hold discussions with the central banks of major countries whose banks are operating here in order, first, to make them aware of the regulatory problems and issues which we have discerned in developing our views on the operations of foreign banks in this country; and, second, to probe their attitudes on possible moves that might be taken here to rationalize the regulatory framework governing the operations of foreign banks in the United States.

Since last May, we have held discussions with seven European central banks. In addition, the subject has been raised informally with R. W. Lawson of the Bank of Canada with a view to holding further discussions in Ottawa at an early date (November or December). Similarly, discussions with a representative of the Bank of Japan indicate the need for conferring with the Japanese in the near future (January - February). Moreover, on November 12 at Basle, we reviewed with the Governors of the central banks attending the November BIS meeting some of the issues arising in our discussions thus far. As a result of that review, some additional contacts in Europe appear desirable even though our visits with the individual European central banks may be regarded as having been completed.

President Zijlstra suggested,that once the Federal Reserve had tentatively formulated a general posture toward U.S. banks abroad and foreign banks in the United States, another discussion at an early Basle meeting would be useful in promoting a common attitude and approach.

At present, within the Common Market, a committee is functioning with the objective of standardizing conditions of banking entry into any one member country by banks in another member country. Subsequently, the work of this committee will extend to the scope of banking activities permitted in the EEC and the regulatory standards to be applied. With the imminent entry of Britain and Denmark into the Common Market, these countries are now actively participating in the work of this committee. (Last Friday, for example, the Bank of England liberalized its rules on ownership of the recognized accepting houses, in part to permit banks from EEC countries to participate in British merchant banking.) While we do not believe it would be appropriate for the Federal Reserve to get into a posture of appearing in any way to be negotiating with the EEC, it does seem desirable and important to establish the contacts needed to obtain an understanding of the content and trend of discussions on these banking matters in the Community.

This memorandum reports the tenor of the reactions we have so far received and puts forward the conclusions we have come to as a result of these discussions. Our conclusions are of a preliminary character, since neither in the discussions held nor in our own thinking has it been possible to explore all the aspects of the problem. Nevertheless, the main issues are sufficiently clear in our judgment to enable the Board to arrive at a general policy stance and then to proceed with the detailed work needed to implement it.

Moreover, we believe that there are several reasons for the Board to adopt a policy position on the subject at an early moment: (1) Interest by foreign banks in operating in the United States is becoming more intense; (2) U.S. banks are pushing very aggressively to open more offices abroad; this is a matter of rising concern in Switzerland, and possibly elsewhere, although there seems to be a more receptive attitude toward U.S. entry in Denmark and Norway where no foreign banks now operate; (3) The regulatory situation of foreign banks is already replete with anomalies both here and abroad and further delay will only complicate that situation and efforts to regularize it; entry and regulatory problems arising from international banking in Western Europe are currently under discussion among European central banks and in a committee of the EEC.

The policy posture that we advocate is one of continuing to welcome foreign banking operations in this country under nondiscriminatory regulations that place foreign banks on an equal footing with domestic commercial banks. To achieve uniformity of regulatory treatment, a system of Federal licensing and regulation of foreign bank operations is required. Such a system would replace the present one of State laws and regulations which are of uneven incidence and which result, in practice, in foreign banks obtaining some competitive advantages over domestic commercial banks. Legislative action will be needed and we believe that the Board should now develop legislative proposals that can be submitted to Congress at an early date.

The harmonization of public policy toward foreign bank operations in the United States has two principal aspects: (1) conditions of entry, and (2) scope of activities. These aspects were discussed with foreign central banks in exploring the approaches that might be taken here and the possible consequences.

Entry. The entry of foreign banks into this country is now almost exclusively governed by State laws and regulations. (The Bank Holding Company Act introduces a degree of Federal jurisdiction over foreign bank operations only when they are conducted through State-chartered subsidiaries.) The differences in State laws and regulations limit not only where foreign bank operations can be located but also the organization form through which they are conducted. Most States do not allow foreign banks to operate under any organizational guise whatsoever. Some permit foreign banking operations only through a State-chartered banking subsidiary (e.g., Illinois), while only a few provide latitude to operate under varying organizational arrangements, including branches. Because of these differences, the U.S. banking operations of foreign banks are found in the form of branches, agencies, and subsidiary banks or combinations thereof.

The consequences of this situation include the possibility of foreign banks, by a careful choice of organizational arrangements, providing full banking services in several States, an opportunity which is denied domestic banks. Also, since some foreign governments apply rules of reciprocity of entry on a State-by-State basis, the State restriction can limit the entry of U.S. banks into certain foreign banking markets or circumscribe the organizational form through which entry can be effected.

Under existing law, foreign banks operating here through branches and agencies are not eligible for FDIC insurance nor can they be members of the Federal Reserve System. Because of the former, foreign banks seeking to conduct a full-scale domestic banking business are forced to establish domestic subsidiaries, while the latter allows major international banks to conduct very sizable operations here without being subject to the same rules (e.g., reserve requirements) as the major U.S. banks that conduct an international business.

In sum, foreign banks operating here now have certain competitive advantage and certain competitive disadvantages by comparison with their domestic counterparts as regards the terms under which they may establish and conduct banking operations.

The view of reciprocity that we put forward in discussions with foreign central banks was one of national treatment--i.e., no discrimination between foreign and domestic banks, both being subject to the same requirements and having the same privileges. The following system for regulating foreign banks here would accord with this view:

1. Remove all distinctions based on organizational form and subject foreign banks to the same rules regardless of whether they operate branches, agenc es, or banking subsidiaries. (Credit balances in agencies and investment companies would be clearly defined as deposits.)
2. Permit a foreign bank to conduct a banking operation in any State of its choosing and in the form of its choice but restrict its general banking operations to one State as in the case of domestic banks.
3. Allow branches and agencies, as well as subsidiaries, to carry FDIC insurance.
4. Require membership in the Federal Reserve System for branches, agencies, and subsidiaries of foreign banks with the resulting privileges and responsibilities.

This approach was tried out on the foreign central banks visited. The view of reciprocity postulated was accepted in principle by the majority of the central banks contacted. The Swiss Banking Commission was a notable exception: the position of the Commission was that the rules applicable to foreign banks in Switzerland should apply to Swiss banks operating abroad; it was apparent that that position reflected the views of the Swiss Bankers Association and also a desire for any excuse to keep further foreign banks out of Switzerland. (The spokesmen for the Swiss National Bank did not defend the Commission's views.)

Reservations about this definition of reciprocity were also expressed at the Bank of France and the Bank of Italy. However, those reservations seemed concerned primarily with the practical implications for existing banking operations of their nationalized banks in which they have a proprietary interest. Notably, the question was asked whether this would mean closing down existing banking operations across State lines. It was noted in response that the attitude of Congress toward "grandfather" rights in this area was difficult to forecast, except to say that on past example a fairly lengthy time period would be provided for compliance with any divestiture requirements. Moreover, it was noted that if these banking operations were of an international nature, there was the domestic analog of Edge Corporations owned by U.S. banks and operating in different States and the comparable provision on the Bank Holding Company Act. At the Bank of Franc , in particular, it was asked that the consequences of this approach, favorable and unfavorable, be spelled out in writing so that more detailed and thoughtful consideration might be given to the question.

So far as conditions of entry and the regulation of banking operations by foreign banks in this country are concerned, the approach outlined above was thought reasonable on the whole in these discussions with central banks subject to the same reservations noted above. The objections or reservations that were registered were either without merit (as in the case of the Swiss), or were of the sort that in our opinion can be accommodated through an elaboration of the general position. Nevertheless, it should be recognized that the Board position which we would support could engender repercussions abroad.

On the entry question, one issue which we did not discuss, but which does require attention, is whether entry into this country should be conditioned on equivalent opportunities for U.S. banks to enter the foreign country concerned. And if reciprocal rights of entry are to be required, should they apply across the board or just to the industrial countries with an exemption for the less developed countries?

Activities. The absence of uniform rules governing foreign banks now makes it possible for those operating branches and agencies to engage in nonbanking activities in the United States of the sort not permissible to domestic banks and bank holding companies. Thus far, they have not done so to any significant extent. Still, as indicated in the Schroder case, they may seek to take advantage of this possibility, particularly in areas where they have acquired expertise through home country experience.

The one important area of interest to foreign banks outside the immediate confines of banking is the securities business. A number of securities affiliates have been established, particularly in recent years, by foreign banks both with and without banking operations in this country. Some have seats on regional stock exchanges and efforts are currently being made for them to have direct access to the New York stock exchanges. Intimations are that foreign bank interest in the U.S. securities business is likely to grow.

Our knowledge of the activities of these securities affiliates is incomplete. An effort was made in the course of our discussions with central banks to add to that knowledge and to obtain a better understanding of the motivations for having them and of the importance attached to them by foreign banks. The central banks consulted possessed only general knowledge themselves and were not able to provide assistance on the specifics although some promised to review the situation. In general, it appears that a large part of their activities is brokerage business connected with the investment portfolios they manage for foreign clients and the affiliates serve to save on brokerage commissions. This type of activity is very close to that conducted in trust departments of domestic banks and to that extent does not seem inconsistent with the objectives of the Glass-Steagall Act. It was suggested that a direct approach to the institutions involved would be more productive in terms of enlarging our knowledge.

The potential exclusion of foreign banks from the securities business in the United States (which would equalize their position vis-a-vis domestic banks) was greeted with equanimity by some central banks and the reservations made by others were to allow further thought about the matter, mostly with regard to existing securities operations. Some of the views already indicated about the impact of Federal regulation on banking operations were reiterated in this connection.

Apart from the Swiss, whose views seem singular, the central banks expressing reservations (the French, Italian, and, to a much lesser extent, the German) seemed prepared to review them again after we had more fully explored the facts of these securities operations and were in a position to be more explcit about the implications of the position put forward.

Summation.

The discussions with foreign central banks have helped to clarify and sharpen our thinking about an appropriate regulatory posture toward foreign banks operating in the United States and the interrelated problem of the regulation of U.S. banks in their overseas operations. The view of reciprocity that we hold and which we advanced in our discussions--namely, nondiscriminatory national treatment regulated by the host country--has an obverse side: that American banks in operation abroad be subject to the same opportunities and the same restrictions as indigenous banks in those foreign markets. The general reaction we received on this point of view was favorable in the sense that no fundamental objections were raised as to the Board following such a policy course. However, it is clear that the Common Market has the matter under review and further consultations to ensure that foreign views have been thoroughly taken into account would be desirable.

We believe that the Board should adopt the general policy stance described in this memorandum. If the Board concurs in this recommendation, we suggest the following next steps:

1. Formulation of an internal policy guidance statement on the basis of which the staff could explore with foreign banks operating here the detailed implications of the policy.
2. Development of a formal paper indicating the Board's general posture and listing the ensuing advantages and disadvantages to the operations of foreign banks here. This paper could then be circulated to the foreign central banks as representing the outcome of the discussions with them and at the same time permitting a further opportunity for their comments. Such a paper was particularly requested by the Bank of France.
3. Preparation of a memorandum outlining the legal issues to be resolved in the approach and legislative action necessary to that accomplishment.

Coincident with these steps, it might well be useful to have developed a statement that could be made public at a suitable time which would indicate the Board's active interest in the operations of foreign banks in this country and the fact that measures to regularize their status are under study. The timing of such a public statement should probably await completion of the prospective discussions with the Canadians and Japanese and should take into account the status of the further contacts to be made through the BIS and with the EEC.