MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, December 19, 1972, at 10:15 a.m.[1/]

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

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

Messrs. Morris, Kimbrel, and Clay, Presidents of the Federal Reserve Banks of Boston, Atlanta, and Kansas City, 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, Kareken, and Link, Associate Economists
Mr. Holmes, Manager, System Open Market Account

1/ This meeting was preceded by a joint meeting of the Board of Governors and the Reserve Bank Presidents to discuss certain matters relating to discount rates.

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. O'Brien, Special Assistant to the Board of Governors
Mr. Reynolds, Associate Director, Division of International Finance, Board of Governors
Mr. Chase, Associate Director, Division of Research and Statistics, 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. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mrs. Rehanek, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Sherman, Secretary, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Parthemos, Taylor, Scheld, and Andersen, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, and St. Louis, respectively
Messrs. Bodner and Doll, Vice Presidents, Federal Reserve Banks of New York and Kansas City, respectively
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York
Mr. Bisignano, Economist, Federal Reserve Bank of San Francisco

Chairman Burns invited Mr. Daane to report on the late-November meeting of the deputies of the "Committee of 20" and the December Basle meeting.

Mr. Daane noted that the "Committee of 20" had been created at the recent annual meeting of the International Monetary Fund to carry forward the work of international monetary reform. Negotiations were begun in a 3-day meeting of the deputies to the Committee, held in Washington from November 27 through 29. As the members knew, the United States was represented at the parent committee meetings by Secretary Shultz and Chairman Burns, and among the deputies by Under Secretary Volcker and himself. Jeremy Morse of Britain was chairman of the deputies, and two vice chairmen--Robert Solomon of the Board's staff and Alexandre Kafka of Brazil--had been designated earlier. During the 2 hours of meeting time devoted to procedural matters, two additional vice chairmen were named: Hideo Suzuki of Japan and Duncan Ndegwa of Kenya. Also, it was decided that the deputies should meet next in Paris on January 23-25, and a contemplated joint meeting of the deputies and parent committee, to be held in March, was discussed. Finally, the deputies adopted a work program, of which the first parts were concerned with the adjustment process and with the questions of reserve assets and convertibility.

During the 14 hours of meeting time devoted to substantive matters, Mr. Daane continued, the deputies discussed the adjustment process, including the exchange rate mechanism. Central to that discussion were the views submitted by the U.S. representatives calling for objective indicators of the need for adjustment measures and for the use of reserve figures as the best available objective indicator. The discussion was rather effective despite the fact that a large proportion of the 140 persons present participated in the interchange of views at one point or another during the 3 days. Differences of view appeared early in the discussion, however, and it remained to be seen how well a group of that size could function when it reached the point of trying to settle those differences.

Mr. Daane then observed that he and Mr. Coombs had attended meetings in Basle during the weekend of December 9-10. On Saturday, December 9, the standing committee on the Euro-currency market met for a full-day discussion of the rationale and possible means for controlling flows into that market. Apart from the question of whether controls were desirable, two schools of thought emerged regarding means. One, led most vocally by the German representatives, favored a reserve requirement procedure; the other, led by the Italians, favored some form of open market operations. The discussion was inconclusive, and the standing committee did not submit a report to the governors when the latter met on the following day.

As to the Sunday meeting of governors, Mr. Daane said the discussion at the afternoon session was highly relevant to the

Committee's policy deliberations. Chairman Zijlstra had suggested that during the "tour d'horizon" the governors should address themselves not only to developments in their own countries but also to the question of interest rate developments and discount rate policies in Europe. He expressed his concern that European interest rates might rise to a "trigger point" at which there would once again be significant inflows of dollars that could cause problems for policy in both Europe and the United States.

In his own remarks, Mr. Daane continued, he commented on the reliance this country was placing on a more effective incomes policy and on fiscal policy in terms of the Administration's determination to hold down expenditures. He noted that the System was following a monetary policy of moderate restraint and that, as the Chairman had noted in his recent Congressional testimony, some further uptick in short-term interest rates might be in prospect. He had gone on to indicate, however, that the Europeans should not expect the United States to push up its domestic interest rates in parallel with an escalation abroad, because doing so would tend to disrupt the incomes policy, the success of which was important to all of them. And he agreed with Chairman Zijlstra that there was a critical level for European interest rates at which disturbing flows of funds could develop, adding that he did not know just where that level was.

Mr. Daane went on to say that in summarizing the discussion Chairman Zijlstra noted that there seemed to be general concern about international interest rate differentials arising from differences in the mix of stabilization policies on the two sides of the Atlantic. In his (Mr. Zijlstra's) words, the United States was applying a good dose of incomes policy and combining it with an appropriate mix of fiscal and monetary policies; some European countries were following weak incomes policy but were rediscovering monetary policy--and in the process were risking an overdose of the latter; and the consequence could be flows of funds from the United States to Europe that could simultaneously undermine the U.S. incomes policy and anti-inflationary policies in general in Europe.

In his judgment, Mr. Daane remarked, that discussion was very useful, since it heightened the general awareness of the difficulties that could ensue if European monetary officials pressed too hard and too rapidly toward higher interest rates.

Among other comments of interest during the Sunday afternoon session, Mr. Daane continued, the U.K. representative described the difficulties the British were experiencing in dealing with inflation and expressed the hope that their 90-day wage-price freeze would be extended beyond its present termination date in late February. He gave no clear indication as to when the sterling float might be ended. Also, the Japanese representative made a strong defense of his government's program to reduce Japan's foreign trade surplus, but his remarks were greeted with skepticism.

Mr. Daane observed that the Sunday evening session was devoted entirely to a discussion of the U.S. views that had been advanced at the recent (late-November) meeting of the C-20 deputies concerning the usefulness of objective indicators, particularly reserves. It was quite clear that the Europeans were not enthusiastic about reserve indicators. They argued that changes in reserves of individual countries did not indicate which country was responsible for the flows of funds that were occurring. Also, they thought that under the scheme proposed by the United States, speculative inflows could force countries to act even when action was not required by basic economic conditions. One or two of the governors present stressed that the use of reserve indicators could result in a self-fulfilling prophecy of the need for exchange rate action, because market participants, knowing how the indicator was used, would react to initial reserve changes in a manner that quickly forced the exchange rate to its limit and intensified the changes in reserves.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period November 21 through December 13, 1972, and a supplemental report covering the period December 14 through 18, 1972. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said the exchange markets had presented a rather mixed picture over the past month that was difficult to summarize. In contrast to earlier months this fall, when the dominant feature of the market was the broad improvement of the dollar, the picture in individual currencies over the past month had tended to vary quite widely, depending upon particular developments in the local markets. On balance, however, he thought one could be quite satisfied with the way the dollar had weathered recent events. As the Committee was aware, the Account Management had been particularly concerned about the risk that the strong anti-inflationary measures being adopted in Europe could have serious adverse consequences for the dollar, and that concern was widely shared in the markets. To date, however, the effects had been rather mild and, although there was some general weakening of the dollar earlier in the period since the last meeting of the Committee, exchange rates had tended to come back to the levels prevailing at the time of that meeting. In fact, with the exception of the rate against the Swiss franc, dollar rates today were as good as, or better than, they had been in late November.

The continued relative strength of the dollar reflected a number of factors, Mr. Bodner continued. Fundamental was the underlying economic situation. Recent data and press commentary had pointed to the continuing and growing strength of the U.S. economy at a time when one European country after another had released data pointing to accelerating wage and price inflation. Moreover, the strength of U.S. equity markets had continued to attract funds on a substantial scale. Meanwhile, although there had been a pronounced tightening up of monetary policies in Western Europe, it was clear--as Mr. Daane had indicated--that the Europeans also were concerned about the risks inherent in excessive monetary restraint on their part, and he thought it was fair to say they had been rather careful not to overdo such restraint so far. Finally, one factor that should be kept in mind in this regard was the widespread use of exchange control measures which tended to isolate individual European economies. Because of those measures, the scope for countries to establish domestic interest rate levels different from those prevailing in the international market was significantly greater than it had been in the past. That was particularly true for Germany and Switzerland. He did not mean to suggest that there was no reason for concern; the exchange controls obviously were far from air-tight, and if interest rate differentials reached really large proportions, the inducements to move funds would overcome the present barriers.

Chairman Burns remarked that political conditions in Europe did not appear highly favorable to inflows of capital at present.

Mr. Bodner agreed, adding that he was focusing only on interest rate considerations. He went on to note that the general picture of exchange markets he had described concealed a number of crosscurrents. Despite the sharp rise in interest rates in the United Kingdom, sterling weakened during the past month; last week it was under considerable pressure, and the Bank of England had to spend a quarter of a billion dollars to keep the rate from going much beyond 10 per cent below its previous parity. Although the rate got a boost late in the week from Chancellor Barber's announcement that a new parity would not be established in time for the January entry of Britain into the European Community, the over-all atmosphere remained rather poor. Corporations both here and abroad were showing an increasing disposition to sell forward sterling, and there were reports today that oil producing countries that had bought sterling earlier in the week were selling it on receipt.

Mr. Bodner observed that the French franc also had been quite weak recently, largely because of the concern in France over the possibility of substantial gains by the Left in the forthcoming Parliamentary elections. In the past few days the franc rate had dropped below par, and it was now at the bottom of the EC "snake in the tunnel" range. Despite that substantial rate movement the weakness of the franc should not be exaggerated; the underlying French payments position remained fairly strong and the present situation could provide a useful opportunity for the System to pick up some francs for future use.

The Italian lira remained weak, Mr. Bodner continued, but it was not under heavy pressure. There had been a brief round of substantial selling at the end of November when there were widespread rumors that the Italians would float the lira, but that soon passed and in the last week or so the market had not required any official support. Nevertheless, the market's pessimism regarding the lira remained a threat to stability on the continental exchanges, since further flare-ups were quite possible and could--as in late November--put pressure on the dollar in other centers.

Mr. Bodner noted that there had been a substantial readjustment in the Canadian dollar market, as the outcome of the Canadian election--and the prospect of pressure in Canada to shift toward more expansionary policies--combined with a downward adjustment in

Canadian banks' CD rates, contrary to the trend of rates everywhere else, to bring about a reassessment by banks and major corporations of the near-term outlook for the Canadian dollar. Despite large sales of dollars by the Bank of Canada, the rate briefly dropped below parity with the U.S. dollar. The Bank of Canada's operations in the market during this period brought its total net intervention since the Smithsonian meeting approximately to zero; both purchases and sales totaled roughly one-half billion dollars.

While the dollar had strengthened with respect to most of those currencies, Mr. Bodner remarked, it had, of course, not strengthened with respect to the yen and the Swiss franc. The Bank of Japan continued to make substantial reserve gains as a result of Japan's large current account surplus, although the rate of the inflow had slowed somewhat in part because of an abatement of expectations of an imminent revaluation of the yen. Apparently, there had been some flow of funds from Japan into investments in the United States. The Swiss franc had been affected not only by the tightening of anti-inflationary policy in Switzerland but also by the usual year-end liquidity pressures. Nevertheless, the rate had not moved too far, and the System had been able to continue acquiring Swiss francs. Although the purchases were on a modest scale, it had seemed likely earlier that it would be necessary to withdraw from the market entirely during this period. Repayments of Swiss franc debt totaling $20 million had been made since the last meeting of the Committee, bringing the outstanding balance down to $1,170 million.

Mr. Bodner noted that continued progress also had been made in reducing the System's Belgian franc indebtedness, which had been cut by a further $20 million to $425 million. In addition, in December the Desk had been acquiring Belgian francs in the market to enable the Treasury to meet a December 27 note maturity which would require some $13.5 million equivalent of Belgian francs. After that need had been met he thought it would be possible to continue acquiring Belgian francs at least at the present rate for the System and Treasury combined; if so, the rate of repayment of the System's swap debt could be accelerated.

In that connection, Mr. Bodner continued, Committee members would recall that at the last meeting Mr. Coombs had raised the possibility of the Treasury's issuing dollar-denominated medium-term notes to Belgium and Switzerland as an inducement for them to hold on to their present uncovered balances, while the System took advantage of any easing in the market to liquidate swap drawings. He had been exploring that possibility with the Treasury and, although there still were some details to iron out, the Treasury had agreed in principle and had authorized him to discuss the subject with the Belgians. He expected to do so at the January Basle meeting. With respect to Switzerland, the problem was complicated by the Treasury's desire to use the same technique as a means of reducing its present indebtedness in the form of Swiss franc-denominated notes. Personally, while he thought the Swiss might be interested in acquiring dollar-denominated notes against their present uncovered dollar position, thereby leaving scope for reduction of the outstanding swap debt, he was somewhat skeptical that they would be very anxious at this point to take on such paper in exchange for Swiss franc-denominated paper of similar maturity. That question would be pursued further with the Treasury over the next few weeks.

Finally, Mr. Bodner said, he should report that the System had renewed all of the swap lines that had matured so far, for periods of 12 months. In the case of the lines with Germany and Belgium, the renewals of course included the modification of the revaluation clause that had been agreed upon in July. It was the view of the staff at the New York Bank, concurred in by the Board's staff, that the language agreed upon in July with Germany and Belgium should be incorporated in all of the swap lines, on the principle that all swap partners should be treated equally and that no attempt should be made to hold some partners to conditions that had been modified with respect to others. The Treasury, however, objected, insisting that at most the language employed should be similar to that agreed upon with the EC countries last June. As the members would recall, in June the System agreed to renewal of those swaps--which were then on a 6-month basis--on the understanding that in the event that either party made a drawing a decision would be reached at that time by mutual agreement as to whether the revaluation clause would apply or whether it would have to be modified. It was pursuant to that understanding of June that the agreement on the modified revaluation clause had been reached with Germany and Belgium later in the summer. Thus, the German and Belgian swap lines now carried the modified revaluation clause while all of the other lines were, in effect, subject to negotiation concerning that clause at the time of any drawing. While that formula was acceptable to the other central banks, it seemed to many of them to be a rather curious procedure; they knew the System had already reached a definitive understanding with two of its swap partners and they were puzzled by the reluctance to extend that understanding to all of them at this time. It appeared to him that a fair amount of dust had been stirred up for very little reason, particularly since the other central banks had made it clear that, in the event the System wished to make a drawing, they would insist on the same revaluation clause that had been negotiated with Germany and Belgium.

Mr. Mitchell said he was puzzled by Mr. Bodner's comment that the Treasury had "insisted" on the use of particular language regarding the revaluation clause in System swap agreements with central banks other than those of Germany and Belgium. The implication was that the Treasury, rather than the Committee, was determining System policy in that area.

Mr. Bodner observed that it had been the consistent practice to consult with the Treasury on all substantive questions relating to the System's swap network.

Chairman Burns asked why the Treasury had preferred not to incorporate the language that had been negotiated with the Germans and Belgians into the other swap agreements at this time, and whether their position on that question had created any real difficulties.

Mr. Bodner said he believed the Treasury's preference reflected a desire not to make the kind of concession involved in the new revaluation clause language until it became necessary to do so--that is, until the System wanted to draw on a particular swap line. Such a procedure did not create any serious problems for the Federal Reserve. As he had mentioned, however, it had raised questions in the minds of the System's swap partners.

The Chairman remarked that the Treasury's underlying objective might well have been to avoid any possible implication that the System now planned to draw on other swap contracts for purposes of intervening in markets for a number of currencies.

Mr. Daane said he thought that was the Treasury's view. At the same time, he agreed with Mr. Bodner that the System would have to introduce the new language in the other swap agreements if it did decide to draw on them. He believed that would be agreeable with the Treasury.

Chairman Burns observed that he had not been aware of the discussions on this issue, but if he had participated in them he probably would have felt that the Treasury's position was appropriate. Mr. Bodner had properly considered the question from a central banking point of view. The Treasury, however, had a responsibility for also taking account of broader considerations of the kind he had mentioned.

Mr. Mitchell remarked that he was still concerned about the implication that the Treasury was dictating terms to the Federal Reserve. He asked why the Account Management had proceeded to negotiate the swap renewals on the basis desired by the Treasury rather than referring the matter to the Committee.

Mr. Bodner replied that the issue had not appeared important enough to warrant the latter course; as he had indicated, no serious problems had been created for the System.

The Chairman said he thought a distinction should be made between the System's domestic open market operations and its foreign currency operations. With respect to the former, the System was, and had to remain, entirely independent of the Treasury. With respect to the latter, however, while the System was independent from a legal point of view, in practice it was necessary that it act jointly with the Treasury; since actions in the foreign currency area could involve questions affecting the nation's foreign policies, it was appropriate that the Treasury should have a voice in them.

Mr. Daane noted that the Treasury had a direct interest in matters relating to the System's swap network. As the members would recall, the Treasury had agreed in mid-1968 to "backstop" any System swap drawings that could not be repaid within an appropriate period because an expected reversal of international flows of funds had failed to materialize.

Mr. Mitchell said he agreed that the Treasury had a legitimate and vital concern with the operations of the System's swap network. He believed, however, that this was the first occasion--at least, the first of which he was aware--on which the Treasury had, in effect, vetoed an action the Federal Reserve had planned to take. More generally, he thought the question of the relations between the System and the Treasury in the foreign currency area had not been adequately explored by the Committee.

Chairman Burns observed that he, Mr. Daane, and members of the staff were continually engaged in conversations with Treasury officials on questions relating to System foreign currency operations. While those officials sometimes expressed their views with considerable force, it was not his impression that they attempted to exercise vetoes. Nevertheless, he thought there were some important implications in Mr. Mitchell's remarks. It was quite possible that the System people involved in discussions with the Treasury were not doing an adequate job of keeping the full Committee informed about those discussions. And it might well be desirable for the Committee to have a thorough discussion of the whole question of its relations with the Treasury in connection with foreign currency operations. If the members were disturbed about the implications of those relations for the independence of the Federal Reserve, they might conceivably decide to terminate System foreign currency operations.

Mr. Daane commented that he would not deny the possibility that the Committee was not always kept adequately informed about discussions with the Treasury. At the same time, he would note that over the years the Committee had considered the question of System-Treasury relations in the foreign currency area on a number of occasions. For example, in connection with the Treasury's 1968 agreement to backstop System swap drawings, Committee members had had an opportunity to consider successive drafts of a letter from Secretary Fowler to Chairman Martin which dealt with that subject, and which included a statement regarding the desirability of continued consultation between the Treasury and the System on the use of the swaps.

Mr. Bodner observed that provisions for regular consultation and coordination with the Treasury had been made in the initial foreign currency directives adopted by the Committee in 1962. It had been recognized from the inception of System foreign currency operations in that year that in many ways the Treasury had the ultimate responsibility in the foreign currency area and that System activities should always be fully coordinated with those of the Treasury. Moreover, System foreign currency operations had in fact been carried out on that basis over the years. Accordingly, the present situation did not strike him as novel in any way; and, as the Chairman had indicated, it was not unusual for the Treasury to express its point of view in strong terms.

Mr. Hayes concurred in Messrs. Daane's and Bodner's remarks. He added that during the whole 10-year period in which the System had engaged in foreign currency operations it had endeavored to work in concert with the Treasury. The Committee had decided very early that it would not undertake any operations which the members considered inappropriate simply on the basis of a request from the Treasury; but it had also been understood that if the Treasury had serious questions about any operations the Committee was contemplating, those questions would be given careful consideration.

Chairman Burns remarked that he had no disagreement with Mr. Hayes' observations. He might note, however, that Mr. Hayes had the opportunity to keep intimately informed about the operations in question from his vantage point at the New York Bank. On the other hand, Mr. Mitchell--and other members of the Committee--might well have good reason for believing that they were inadequately informed. If his (Chairman Burns') recollection was correct, in the period since he had become a member of the Committee questions of basic principle and procedure had rarely, if ever, been raised during the deliberations on foreign currency operations.

Mr. Hayes observed that there had been such discussions at earlier times.

Mr. Daane added that in 1966, at the instance of Governor Maisel, a detailed examination of System foreign currency operations from 1962 through 1965 had been prepared by the staff and considered by the Committee.

Mr. Sheehan suggested that it might now be time for another full discussion, and Chairman Burns proposed that the Committee plan on following that suggestion.

By unanimous vote, the System open market transactions in foreign currencies during the period November 21 through December 18, 1972, were approved, ratified, and confirmed.

Mr. Bodner reported that three System drawings on the National Bank of Belgium, totaling $95 million, would mature in the period January 5-26, 1973. As he had indicated, progress continued to be made in paying down the System's swap debt in Belgian francs. However, he could not say at this point whether the drawings in question would be repaid by their maturity dates, and therefore he requested Committee approval for their renewal if that should prove necessary. Specific Committee action to authorize the renewals was required under the terms of paragraph 1(D) of the foreign currency authorization, since the Belgian swap line had been in continuous use for more than one year.

Chairman Burns remarked that, while he meant to imply no criticism of the Account Management, he felt that the progress in repaying the System's outstanding swap debts was quite slow. At the repayment rates of the past month the System would remain indebted for a long time.

Mr. Bodner said the Desk was pressing to acquire the Swiss and Belgian francs needed as rapidly as it thought market conditions would permit. Acquisitions had been reduced last month because of the market conditions prevailing, and he hoped that they could be accelerated early in the new year.

Chairman Burns noted that in the past the System had not always relied wholly on the market as a source of foreign currencies needed for swap debt repayments; on occasion it had obtained some of the needed currencies in exchange for dollars directly from the central bank involved. In any case, he thought an effort should be made to develop a plan for repaying the System's remaining debts as rapidly as feasible.

> By unanimous vote, renewal for further periods of 3 months of the three System drawings on the National Bank of Belgium maturing in the period January 5-26, 1973, was authorized.

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

Mr. Partee made the following statement:

> You may have noted that the current issue of the green book[1/] has a red spiral binder rather than a white one. This is intended to mark the holiday season, of course, but one might wonder whether this year it could also be signaling danger on the economic

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

scene. Certainly the buildup of steam in the economic boiler has been rapid of late, and this is bringing with it a sense of uneasiness and concern even though the pressure reading is still some distance from the bursting point. Increases over recent months that have averaged 12 per cent in industrial production and well over 3 million in nonfarm employment--both at annual rates--are absorbing significant amounts of unused resources and clearly cannot be sustained for any very extended period of time.

Rising rates of resource use, moreover, appear fully supported by the strengthening of demands throughout the private sector of the economy. Retail sales in October and November were sharply higher than in the third quarter, and Christmas trade thus far appears to have been very good. Business capital spending plans, according to the latest Commerce-SEC survey, are scheduled to be rising sharply in the current quarter and on into early 1973, following a considerable shortfall last quarter. Confirmation of the survey findings is provided by the upward trends in equipment orders and output and in construction contracts for commercial and industrial building. Business inventory data indicate a step-up in rates of accumulation over recent months, on a book value basis, and more frequent reports of slower deliveries suggest the need for a further substantial buildup in stocks still to come. Even housing activity continues to look very strong. Starts in November continued at the fast October pace--in excess of a 2.4 million annual rate--and the latest report (for October) shows a new high in home sales by merchant builders.

Despite these many signs of added strength in the economy, we have not appreciably revised our GNP projections from those presented 4 weeks ago. Partly this is because the increases we have seen are consistent with our prior expectations for a very strong fourth quarter, and, as members of the Committee noted last time, for greater continuing strength in 1973 than has been anticipated by most private forecasters. Partly, also, we feel that some additional impetus in the private sector might be offset by lower Governmental outlays than we had been assuming. This seems to be true to a degree in the current quarter, with defense spending apparently continuing to run below projections, and it would be true for the remainder of the fiscal year if total expenditures are held at or below $250 billion, as the Administration has again indicated will be the case. The sudden reversal in prospects for peace in Vietnam may upset these plans, by preventing further near-term reductions in defense spending, but should probably still be regarded as a bearish development because of the adverse effects likely on public psychology.

Nevertheless, I would think the risks in our projections are that activity may expand more than we are anticipating over the months ahead. I should note that the preliminary, highly confidential, Commerce Department estimate is for real GNP growth in the fourth quarter of 8-1/2 per cent, annual rate, rather than the 7-1/2 per cent gain we have projected. Looking further ahead, business inventory accumulation, capital spending, and residential construction could all turn out stronger than we are anticipating, and it is unlikely that this would be fully offset by lower-than-projected consumption or Governmental expenditures. If so, employment, output, and incomes would also rise somewhat faster than we have projected, and resource utilization rates could rise significantly further by mid-1973, tending to put more upward pressure on the structure of costs and prices. In any event, the rate of price increase may well prove to be somewhat faster than we have projected. Farm product prices have increased substantially at wholesale in recent weeks and the rise in average hourly earnings, though slower in November, is still indicated to have accelerated over the period since mid-year.

Given the rapidity of the runup in major economic indicators over recent months, and the rather marked reduction in resource slack that is taking place, it would seem prudent to begin exerting some additional monetary restraint on the financial system. Rather than erring on the side of restraint, however, recent rates of monetary expansion have tended to exceed our expectations and the Committee's desires. It seems to me of great importance to avoid any acceleration in monetary growth rates. Indeed, I think that it would now be desirable to aim for monetary growth somewhat below the 6 per cent target for M_1 previously specified by the Committee, in view of the lags with which policy changes take effect and the rise in the odds that economic expansion may outrun our expectations.

> Any attempt to restrict monetary growth in the current ebullient environment would undoubtedly produce significant upward adjustments in interest rates and apprehension about future credit availability. Such adjustments must be gradual and orderly, of course, but they are in keeping with the need to exert a degree of restraint on private sector plans, including plans for credit-financed expenditures. In sum, I would recommend the longer-run targets for alternative C of the draft directives,1/ but with a constraint on the speed and extent with which higher market interest rates would be sought. The Federal funds rate was below 5 per cent only 3 weeks ago, and I doubt that the needs of the Treasury and others for orderly market adjustments would be facilitated if that rate should rise consistently above 6 per cent during the interval until the Committee's next meeting.

Chairman Burns referred to Mr. Partee's observation that the Commerce Department was estimating fourth-quarter growth in real GNP at an annual rate of about 8.5 per cent, compared with the Board staff's projection of 7.5 per cent. As he understood it, the Department also was estimating that the GNP deflator would rise in the current quarter at a rate of 2.3 per cent, compared with the Board projection of 2.8 per cent. For the private, fixed-weight deflator, which was by far the more reliable measure, the rate of increase was estimated at 2.7 and 2.9 per cent, respectively, by the Department and the Board. He mentioned those figures only for information of the Committee.

The Chairman then noted that the unemployment rate had declined sharply from October to November, from 5.5 to 5.2 per cent. He asked for Mr. Partee's best judgment about the likely figure for December.

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

Mr. Partee remarked that the decline in the unemployment rate in November was a product of a reduction in the size of the labor force and a small rise in employment, as reported in the household survey. The labor force decline was quite likely to be reversed in December, and the unemployment rate then might well be higher than 5.2 per cent. However, the extraordinary increase in nonfarm employment that had been under way during the past 4 or 5 months undoubtedly was serving to reduce the slack in available labor resources in a real sense, and that should be reflected in a downdrift in the unemployment rate over time.

In reply to a question by Mr. Mitchell, Mr. Partee said that while the staff had not yet fully assessed the implications of the most recent developments for its GNP projections for 1973, his present inclination would be to raise the figures somewhat.

Mr. Mitchell then noted that in the staff's chart presentation at the previous Committee meeting Mr. Wernick had made the following comments with respect to the outlook after the first quarter of 1973: "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." He asked how Mr. Partee's evaluation of prospects for those major sectors had changed since the chart presentation.

In reply, Mr. Partee said he might first note that he still expected growth in GNP to slow over the course of 1973, for reasons similar to those Mr. Wernick had cited in the chart show. However, the latest figures suggested that gains in all major sectors might be proceeding so rapidly as to pose a substantial risk of an accumulation of upward pressures in the first half of the year that considerably exceeded expectations. In such an environment, the further stimulation of consumer spending that would result from the distribution of tax refund checks might well destroy the basis for an orderly adjustment to the lower rate of growth expected in the second half. In any case, his main concern was with the first half. In that period business inventory investment could be greater than the staff projections suggested, and residential construction might well be stronger than projected. With respect to housing, he had been most impressed by the report he had mentioned on home sales by merchant builders in October, and also by data indicating that new apartments coming on to the market in the third quarter had been absorbed at a faster rate than a year earlier, even though apartment building was proceeding at a rapid pace. Business fixed investment spending in the early part of the year might also rise more than projected. While the results of the latest survey on plant and equipment spending plans in themselves were not disturbing, he had been impressed by the large number of new building projects cited in the red book[1/] reports for various Federal Reserve Districts.

Mr. Partee said he wanted to emphasize that the staff had decided not to make any significant changes in its formal projections at this time despite such indications that a further strengthening in prospects might be under way. Accordingly, his comments should be taken as indicating only that when revisions were made he believed they were more likely to be upward than downward.

Mr. Mitchell remarked that it seemed to him vitally important to know whether the latest data warranted a substantial modification of the projections; a judgment that the tempo of the economy might be significantly different in 1973 from that expected earlier could well prove to be the straw that tipped the course of monetary policy in one direction or the other. He gathered that Mr. Partee's concerns were stimulated more by an apparent shift in psychology than by movements in statistical measures of business activity. It was also worth noting that, given the lags in monetary policy, a policy change now would probably have little effect on activity in the first half of next year, and according

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

to Mr. Partee it still appeared likely that the economy would undergo a letdown in the second half.

Mr. Partee replied that, while the terms on which credit was available over coming months might have little effect on actual activity in the first half, they would affect the plans and decisions made then. His point was that in deciding on current policy the Committee would no doubt want to take into account the fact that the economy could well be expanding at an even more rapid rate than had been projected for the first half.

As Mr. Mitchell had suggested, Mr. Partee continued, his attitude had been influenced by psychological considerations, including the attitudes of other economists. For example, at a meeting of the Conference of Business Economists he had attended about a month ago, the outlook was seen as highly bullish. And just yesterday he had read a report of the last luncheon meeting of Chicago-area economists sponsored by the Reserve Bank which was more bullish than any he could recall as having emanated from that quarter in the past. However, he had also been influenced by the recent steady stream of upward revisions in statistics on business activity, including the statistics on industrial production, employment, and retail sales.

Chairman Burns observed that there had not been an upward revision in the figures on business capital expenditures.

Mr. Partee agreed. However, he said, it was interesting to note that the component of the production index for nondefense business equipment had been rising at an annual rate of about 20 per cent over the past several months. Taken together, the recent patterns in the data suggested that there was very real strength in the economy.

Chairman Burns said there was no question but that the economy was showing real strength and that the advance was brisk. There was a danger, however, of concluding prematurely that a run-away boom was in process. He then asked how the current expansion, taking November 1970 as the turning point, compared with earlier business cycle expansions.

Mr. Partee replied that the rate of increase in physical measures of activity since November 1970 seemed to be about equal to the average in earlier expansions over periods of corresponding length. The dollar measures of activity had risen more this time, of course, because the rate of price advance had been faster than the average for previous expansions. He might add that the profile of the expansion from November 1970 was quite different from that in earlier recoveries; the advance was quite slow until August 1971, and then it accelerated. If one arbitrarily took the latter month as the turning point, the current advance would be considerably faster than in earlier recoveries.

Mr. Morris observed that he had spent some time last week comparing growth rates since November 1970 with those in the recovery that began in February 1961. For periods of equal length the average growth rates were about the same. The earlier recovery was rather slow in developing, and the growth rate in real GNP in the early quarters of the current expansion was slower still. In the most recent quarters, however, real GNP had risen much more sharply than in the corresponding quarters of the earlier recovery. Similarly, the leading indicator series generally had been rising more rapidly in recent months than at the corresponding period of the earlier recovery.

In reply to a question by the Chairman, Mr. Morris said he had not employed deflated forms of those leading indicators which were influenced by price changes. He was confident, however, that even after adjusting for price changes the figures would indicate that the current expanion was accelerating more rapidly now than the earlier recovery had.

Mr. Daane said three related questions were prompted by Mr. Partee's policy recommendation. The first was whether the Committee should try to compensate within a short period for an overshoot or shortfall in the monetary aggregates; he gathered that Mr. Partee favored compensation for the recent overshoot. The second concerned the likely interest rate consequences of a sudden shift to the lower aggregate growth rates that Mr. Partee recommended. Personally, he thought the effect on interest rates would be much greater than suggested in the blue book.[1/] Finally, he wondered what meaning would attach to the notion of a "longer-run" target if the Committee reacted to a temporary overshoot in the manner Mr. Partee proposed. Considering the 2-year period ending last December as a whole, M_1 had grown at the desired annual rate of 6 per cent; and in the 3 months ending in November, the growth rate had been below 6 per cent. If the targets were really intended to apply to the longer run, he thought the Committee should not modify them simply because of short-run misses.

In reply, Mr. Partee said he might first attempt to clarify the recommendation he had made. Briefly, he had meant to suggest that a tightening of monetary policy was needed at this time, and that the degree of tightening that might be sought was a function of the Committee's judgment as to how fast interest rates--particularly the Federal funds rate and the related community of market rates--could be permitted to rise under prevailing circumstances. With respect to the aggregates, his recommendation for shifting from a 6 to a 5 per cent longer-run target growth rate for M_1 had nothing to do with the recent overshoot. Rather, it reflected his view that there was enough of a threat of excessive economic

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

expansion and of developing inflationary pressure to call for a small but fundamental change in the stance of policy.

Mr. Hayes remarked that he concurred completely in the observations Mr. Partee had just made. As to the general economic outlook, the New York Bank's GNP projections were almost identical with those made at the Board, and like Mr. Partee he thought the main risk was that the projections were too low rather than too high. While he would not say that boom conditions were clearly prevailing now, the pervasiveness of bullish developments suggested that a boom psychology might not be far off.

In his judgment, Mr. Hayes continued, the "reentry" into a high-employment zone might not prove to be as smooth and controlled as had been hoped earlier. He recognized that a 5 per cent rate of unemployment was certainly too high from a social standpoint, but he wondered how much below 5 per cent the unemployment rate could go without accelerating the pace of inflation and generating pressures too strong for a wage-price control program to keep in check. As to prices, recent developments had been mixed but somewhat discouraging on balance. An analysis at his Bank suggested that the underlying rate of increase in the consumer price index--discounting temporary fluctuations in both directions--was in the neighborhood of 3-1/2 per cent, in contrast to a rate close to 3 per cent that seemed to be prevailing a few months ago.

He did not see much basis for expecting improvement in the price picture, at least in the absence of more stringent controls on specific prices. Indeed, given the signs of tightening evident in scattered markets, and with the economy as strong as it was, he thought it would be reasonable to expect some further deterioration in the behavior of prices.

Chairman Burns said he might note in that connection that, according to information he had received this morning, when the CPI for November was published later this week it would show a sharp increase in retail food prices.

Mr. Mayo observed that analysts in the Chicago area were quite concerned about the effect of recent poor weather on prices of such products as soybeans and cattle. Agricultural prices might well prove to be a serious problem after the turn of the year.

Mr. Mayo then remarked that the level of the Board's statistical series on the rate of capacity utilization in manufacturing, which was currently about 82 per cent, often was cited as evidence that there was no need to worry about a boom developing soon. While he was aware of the dangers of anecdotal analysis, he thought it was worth mentioning that several of the directors of the Chicago Reserve Bank--including one whose company was the largest employer in Illinois--reported that their companies were operating at capacity. Those directors were highly skeptical of statements that a large volume of capacity remained unused nationally.

In any case, Mr. Mayo continued, it was clear that the present series was an inadequate measure, and that manufacturing capacity would be fully employed well before the series reached the 100 per cent level. He asked whether any progress had been made in developing a better measure. If not, he wondered whether one could specify the level of the present measure that might be taken as equivalent to full use of capacity.

In reply, Mr. Partee observed that the problems with the utilization measure were related in large part to the extreme difficulty of distinguishing between commercially or economically feasible capacity and uneconomic capacity existing in old plants. The basis for the present series was supplied mainly by company-wide estimates of operating rates obtained by McGraw-Hill early each year in connection with their survey of business plans for plant and equipment spending. The Board's staff was now exploring the possibility of improving the basis for the series through an annual Census Bureau sample survey of managers of individual plants, asking for their estimates of economically feasible capacity. At the moment the staff was analyzing the results of a pilot study that had been made by Census; if those results were encouraging a full-fledged survey would be proposed during the coming year which should provide the basis for a revision of the current series. He should add that even plant managers might have serious difficulty in responding to questions on feasible capacity, since their answers would depend to an important extent on the assumptions made.

With respect to Mr. Mayo's second question, Mr. Partee said he used to consider the 90 per cent level of the capacity measure as representing a "pressure point." Now, because of problems of obsolescence, pollution control, and so forth, he would be inclined to say that when the index was at a somewhat lower level--say, 86 or 87 per cent--manufacturing output was probably approaching its maximum.

Chairman Burns remarked that he no longer paid much attention to the capacity use series because of its serious limitations. He noted, however, that the staff had recently provided him with some highly interesting statistics--through the year 1968, he believed--on the average age of equipment for individual industries. Evidently such figures were not collected systematically.

Mr. Partee said he believed the figures the Chairman referred to had been based in part on data from the Censuses of Manufactures.

Chairman Burns remarked that it could prove highly useful to have such figures on a more current basis. For example, they could throw light on the relative progressiveness of different industries, even though there would be some problems of interpretation--thus, if the average age of equipment was the same in two industries, that would not necessarily mean that the degree of progressiveness was the same because the types of equipment would differ. If figures on average age of equipment by industry also were available for other countries, they would permit useful international comparisons. He was not at all sure that the systematic collection of such figures would prove feasible, and he thought it might well be desirable to have the matter considered by an interagency committee. If the verdict was favorable, that committee might look into the best means of organizing the regular collection of the data.

Mr. Kimbrel said he concurred in Mr. Partee's suggestions for policy. He also shared the view that the available statistics were not wholly consistent with the ebullient tone of the red book. Some of the directors of the Atlanta Bank, as well as some of the businessmen with whom he had recently visited, seemed to be a bit overenthusiastic about the economic outlook. While the available data for his District did indicate that activity was expanding at a satisfactory rate, they did not suggest to him that a boom was under way. Employment in the District was not rising significantly faster than in the nation as a whole, and apart from Florida and Tennessee it was rising more slowly.

However, Mr. Kimbrel continued, in individual areas--and in Atlanta in particular--a commercial boom seemed to be under way. Hardly a week passed without an announcement of some large-scale project, such as a major industrial installation or a large hotel or motel complex, and an atmosphere approaching euphoria seemed to prevail. In light of such developments and attitudes, it was not hard to conclude that an unsustainable boom could be developing, and that the Committee had to be on guard against an overly rapid expansion in the monetary aggregates.

Mr. Coldwell remarked that, on returning to his office about a week ago after an absence due to illness, he found from talking with some of the business directors of the Dallas Bank that their attitudes had changed markedly over the past month. They were quite pleased by current developments in their industries, and their attitudes resembled those Mr. Kimbrel had found in his District. They expected business conditions to be very good for at least 6 months and perhaps longer, and they were making their plans on the basis of an expected expansion in sales and profits over the next 6 months of more than 10 per cent. They were scheduling additional overtime--partly because of inventory problems and difficulties in meeting delivery schedules--and were planning to make rather substantial capital investments in coming months. He was somewhat surprised to find that a few District businessmen were beginning to weigh the possibility that wage-price controls might be eliminated and to consider what actions their companies might take in that event.

In reply to a question by Chairman Burns, Mr. Coldwell said the businessmen with whom he had talked believed that their present prices were not markedly out of line with those of their competitors, and that demand conditions would not permit large price increases even if the controls were eliminated. They were concerned about forthcoming wage negotiations, but apparently not more so than usual; they did not seem to be particularly worried about the possibility of large wage increases, with or without controls.

The Chairman observed that he had received a somewhat different impression of businessmen's attitudes about the outlook for wages in his own sampling, which admittedly was unsystematic. But when businessmen did not appear greatly concerned about prospective wage increases--even in the absence of controls--at a time when the economy was advancing briskly, he was inclined to wonder whether their attitude did not reflect the view that they would be able to meet higher wage costs through higher prices.

Mr. Coldwell remarked that that interpretation might well be the proper one in cases he had mentioned.

Mr. Heflin noted that he had met last week with the directors of the Richmond Bank and then separately with the directors of each of the two branches. In each of those three meetings, business directors reported the existence of labor shortages in their areas; some indicated that the problem was reaching bottleneck proportions. It would seem that more progress had been made in reducing unemployment than indicated by the official statistics.

Chairman Burns said he would prefer to say that more progress had been made than indicated by the official statistics on over-all unemployment. When the over-all figures were broken down by age, sex, and marital status, they revealed tremendous progress. Unemployment was now concentrated primarily among teen-agers and very young adults; for the rest of the population--the bulk of the labor force--the rate was approximately at the full-employment levels reached in earlier periods of business expansion.

Mr. Heflin concurred in the Chairman's observation. Continuing, he noted that the staff projections suggested some further reduction in the over-all unemployment rate during 1973. Altogether, he thought the Committee would be justified in feeling that it had happily been relieved of some of its earlier concern with the unemployment rate, and that it could now concentrate more on the other constraint--relating to interest rates--under which it had been operating.

Mr. Francis said he would like to report on certain developments at a meeting in St. Louis last week with a group of 8 or 10 business leaders from companies that operated in national or international markets. A year ago, a solid majority of the group probably would have indicated that they favored the wage-price controls that had then just been adopted. While no formal vote was taken at last week's session, he suspected that at least half, if not more, of the businessmen present would have expressed a preference for continuing the control program a while longer. Many of their observations, however, were concerned with the problems produced by the program. For example, they talked a great deal about the distortions it was creating, as when a company would drop a product line because the product prices could not be adjusted to cover higher costs. They used the word "subterfuge" to describe the tactics some companies were employing, including changes in product mix, to raise the permissible price on particular products. A propos the discussion earlier today of capacity utilization rates, two or three of the firms represented had decided not to bring certain idle plants back into production because the prices they would be allowed to charge for the products were insufficient to justify the outlays necessary to meet ecological requirements.

Chairman Burns said he found the observation Mr. Francis had just made to be particularly interesting. Problems of that kind might well become quite important.

Mr. Francis said that would be his expectation. He would note only one of the other kinds of problems arising under the control program that had been mentioned at the meeting. A steel company had sought 2 or 3 years ago to achieve a substantial increase in productivity at a particular plant by investing heavily in labor-saving devices. Unfortunately from their viewpoint, their profits happened to be low in the base year used under the program. As a result, they now found that they could not put the plant into full production because of the penalties that would be associated with the profits earned.

Mr. Sheehan remarked that the company in question could consider the alternative of lowering product prices.

Mr. Francis replied that that alternative certainly would be worth investigating, but he was not sure where the balance of considerations would fall. Finally, he might mention one other local development of interest, of which he had learned through the press. In one of the major building trades a committee consisting of management and labor representatives had voted unanimously to use part of the assets of the pension fund to pay the workers a Christmas bonus. The size of the bonus was calculated to offset the earnings lost earlier in the year because the Wage Board had not approved the full amount of a wage increase that had been negotiated.

Mr. Brimmer referred to Mr. Heflin's comments about the unemployment rate and remarked that those comments might almost be interpreted to reflect a view that the Committee could now disregard the unemployment problem. He was sure Mr. Heflin had not intended such an interpretation.

Mr. Heflin said he had not; he had been thinking in terms of relative emphasis only.

Chairman Burns expressed the view that the Committee would want to continue to give unemployment a high priority, with a full awareness of the developing situation.

Mr. Brimmer observed that that would be his preference. It was worth noting that some groups, such as blacks, had made virtually no gains in employment this year, and that women and young people were becoming an increasingly important part of the labor force. Perhaps aggregate demand management policies could not do much about the continuing unemployment problems among such groups, so that special measures would be needed. Even so, however, it was important for the Committee to keep those problems in mind.

Mr. Robertson remarked that a reduction in the minimum wage might well be desirable in order to enable more young people to find jobs.

Chairman Burns commented that it would be useful in that connection to have a lower minimum wage for teen-agers than for adults. Such a distinction was most likely to come about by maintaining the present minimum for teen-agers when that for adults was increased.

Mr. Winn said he had been disturbed by newspaper headlines this past week indicating that Federal pay rates would rise as of January 1 by 5.2 per cent to compensate for cost-of-living increases. While he understood that the reason given for the rise was inaccurate, he thought those headlines contributed significantly to inflationary psychology.

Mr. Partee remarked that such reports were, indeed, inaccurate. The increases in question, which were required by law, were intended to maintain comparability between Federal and private industry pay scales, not to compensate for increases in the cost of living.

In reply to questions, Mr. Partee said the 5.2 per cent rise in wage rates applied to Federal civilian employees; members of the armed forces received somewhat larger increases. The size of the increase for civilian workers was based on comparability studies made by the Bureau of Labor Statistics last April for specific types of work. The increases originally had been scheduled to become effective last October, but they were delayed until the first of the year by administrative action of the President.

Chairman Burns commented that it was rather difficult, against the background of a 5.2 per cent pay raise for Federal workers, to think seriously about a reduction in the present 5.5 per cent guideline for private pay rates.

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 November 21 through December 13, 1972, and a supplemental report covering the period December 14 through 18, 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:

> Over the period since the Committee last met, growth rates for RPD's and the aggregates--as the written reports to the Committee have indicated--appeared to be running at or above the upper end of the ranges of tolerance specified by the Committee. As a result the Desk became an increasingly reluctant supplier of reserves, moving cautiously because of uncertainty about the statistics which had to be adjusted to take account of the recent regulatory changes. The move toward more stringent

reserve conditions was steady, however, with the Federal funds rate expected to rise by about 1/8 of a percentage point week by week from 5 per cent early in the period to close to 5-1/2 per cent--the upper limit of the range of tolerance specified by the Committee--at the end. With nonborrowed reserves supplied reluctantly, there was, of course, increased use of the discount window as banks sought to meet their reserve requirements.

Other short-term rates also rose along with the Federal funds rate, but it does not appear that the market has fully adjusted to the new Federal funds rate thought to be consistent with the present level of reserve availability. Some rise in short-term rates had been widely anticipated because of the high rate of economic activity, the seasonal increase in credit demands, and the added $4.5 billion supply of Treasury tax-anticipation bills and $1.8 billion of 1-year bills. The market supply of bills was further augmented by net sales in the market by foreign central banks. In the most recent regular auction of Treasury bills, conducted last Friday to avoid mail delays in the Christmas season, average rates of 5.09 and 5.30 per cent were established on 3- and 6-month bills--up about 30 and 18 basis points, respectively, from the rates established in the auction just prior to the last Committee meeting.

Other short-term rates--on certificates of deposit, commercial paper, and bankers' acceptances--also rose, but only by about 1/8 of a percentage point or a little more. Prime rates of major commercial banks were unchanged, however, with 5-3/4 per cent the most widely quoted rate. The rise in market rates and the likelihood of increased competition in the CD market will tend to put increasing upward pressure on the prime rate in the period that lies ahead.

Yields on Treasury coupon issues also rose over the period, by about 10 to 20 basis points in both the short-and long-term categories. Yield increases in the 2- to 7-year maturity categories were held back by Desk purchases for foreign accounts, permitting dealers to reduce their positions in this sector. At the close last Friday dealer positions in Treasury coupon issues maturing in more than 1 year--at only $10 million--were very light. Yesterday they moved into a net short position of over $70 million.

In other long-term markets, corporate bond yields--which had been moving down since September--tended to drift a bit higher, while municipal yields were relatively steady.

The Treasury, as you know, announced last Thursday a routine offer of $2 billion of 2-year, 5-7/8 per cent notes to be auctioned tomorrow. The issue had been expected by the market and early ideas anticipated that the notes would be sold at a small premium. The Treasury also announced last Friday its plans to sell $500 million to $750 million 20- to 30-year bonds to raise needed new money in early January. This offering had not been generally expected in the market and the early reaction was generally favorable, with somewhat mixed ideas about the appropriate coupon and likely investor response. The initial impact on market prices of longer-term Government issues was only moderate, but there was a more pronounced reaction in the market for long-term Federal agency issues.

Only minimal even keel considerations are involved in tomorrow's 2-year note auction. The long-term bond auction, on the other hand, presents a more serious problem since it is of longer-run importance that the Treasury's reentry into the long-term market be reasonably successful. Our ability to move as rapidly as we have in the past month to change reserve conditions and the Federal funds rate is therefore apt to be inhibited until about mid-January. We should, however, at least be able to consolidate the current 5-1/2 per cent rate.

Open market operations over the period had to contend not only with the need to be steadily more restrictive in the supply of reserves but also with the uncertainties of the reserve projections as float became an extremely elusive statistic because of the changes in the check collection practices stemming from the changes in Regulation J. In addition, last week the Treasury balance proved equally hard to predict since revenue-sharing checks were cashed in much more slowly than had been anticipated. For example, over the last weekend actual reserve availability fell nearly $1 billion per day short of our expectations, with float and the Treasury balance estimates about equally responsible. A good part of the shortfall in nonborrowed reserves was made up by a jump in borrowing at the discount window, indicating that we will probably wind up the week with a rather deep net borrowed reserve position.

As a result of the erratic behavior of float and the Treasury balance, open market operations had to be quite flexible, with large temporary reserve injections or withdrawals made in order to achieve desired over-all reserve conditions. On balance, I believe we were reasonably successful in meeting those objectives, and in the process the Committee's range of tolerance for the Federal funds rate was fully utilized.

Looking ahead, even keel considerations will at least inhibit open market operations over the period ahead, even though they may not completely preclude some further modest firming if aggregate growth is exceeding the Committee's desires. As noted earlier, we probably have not had a full market reaction to the degree of reserve stringency already reached. Some further upward pressure on short-term rates thus appears likely. Whether or not a comparable pressure on longer-term markets will be exerted depends in the short run on the market reaction to the Treasury's bond financing; and more fundamentally, on the developing state of the economy, on developments in Vietnam, on the implementation of budget restraint, and on the success of the whole anti-inflationary program. If the recent strength in the aggregates tends to persist, we may be in for a difficult period. It would be most helpful if, in their policy deliberations, members of the Committee would indicate how they would prefer to see the Account Management respond to any potential conflict between even keel considerations and more rapid than desired growth in the aggregates.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 21 through December 18, 1972, were approved, ratified, and confirmed.

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

Before discussing the outlook for the aggregates and interest rates, I would like to emphasize that while we currently expect a 10-1/2 per cent annual rate of growth of M_1 for December, this is based on solid figures only for the first week of the month. Those figures showed a very sharp rise from the week before. We have not been able to find anything special to explain why such a rise occurred in that particular week, either by looking at the behavior of U.S. Government deposits or by examining the distribution of private deposits by size of bank or Reserve District. Weekly seasonal factors are quite variable from year to year, and they may have contributed to a volatile weekly M_1 behavior recently, particularly in light of the impact of revised Regulation J on Federal Reserve float and bank cash items.

Partial figures for the ensuing week also suggest some retreat in M_1 from the early December level, but not enough to indicate that the month on average is likely to see a more reasonable rate of expansion. But in general one ought to recognize that there are pretty good odds that the final result for the month of December could either be significantly higher than now indicated or significantly lower, although I would place longer odds on the latter.

Looking beyond the problem of weekly variations to the fourth-quarter growth in M_1, at the moment it would appear to us to be at around a 7 per cent annual rate, somewhat stronger than earlier projected. I should add that a very preliminary look at the possible revisions from our annual benchmark and seasonal review of money supply figures suggests that the quarter could be a percentage point or so higher at an annual rate than whatever develops under the seasonal factors currently in use. Such a rise would be compensated, of course, by lower measured growth in the other quarters of the year, particularly in the first half.

The recent strengthening in the aggregates, given interest rates, has led us to raise somewhat our estimates of the degree of tightness in money market conditions likely to be associated with moderate longer-run growth in the aggregates--say, that associated with 6 or 5 per cent growth rates in M_1--as compared with estimates at the time of the last Committee meeting. Thus, if the Committee chooses to stay on a 6 per cent M_1 path, we would now expect a funds rate around 5-1/2 per cent, instead of one closer to 5 per cent. If the Committee wishes to work down to a 5 per cent M_1 path, we would expect the funds rate to rise to around 6 per cent over the next few weeks, and perhaps somewhat higher later on, as explained in the blue book in relation to alternative C.

Over the period between now and the next meeting the blue book suggests December-January growth rates for RPD's and the monetary aggregates which are high relative to longer-term objectives. As noted there, the reasons relate to the large December growth that seems already in train and the possible transitory impact of large revenue-sharing payments on money demand in the short run.

But since these December-January ranges are above longer-run targets, and in light of the recent overshoot, the Committee may wish to consider an asymmetrical interpretation of the ranges. That is, if growth in the aggregates does fall short of the lower end of the range, the Committee may wish the Desk to reduce reserve provision commensurately--and thus keep money market conditions from easing--so as to take the opportunity immediately to offset recent excess growth. On the other hand, if aggregates are running high in the range, or moving above the range, the Desk could be instructed as usual to restrain reserve provision through open market operations with a consequent firming in money market conditions. Such an asymmetrical interpretation could apply to any of the ranges presented, but particularly to those for alternatives B and C.

If the Committee were to opt for alternative B, we would expect very little further tightening in money market conditions. However, if the Committee were to opt for alternative C, we would expect a significant further tightening of money market conditions to develop. This could lead to a fairly strong reaction in credit markets. It is not that the technical condition of markets is particularly weak, although dealers appear to hold relatively large inventories of corporate and especially of municipal bonds. But the markets have not yet adjusted to the money market tightening already in process; two new Treasury cash offerings are in immediate prospect; and peace negotiations are now more shrouded in

> uncertainty. Thus, if money market conditions should begin to tighten further as the Desk holds down reserve provision, short-term rates generally could adjust upwards rather substantially, and also long-term rates, though to a lesser degree.
>
> In those circumstances--and with the wage-price program being reformulated and the Federal budget being put together--the Committee, if it moves in a tightening direction, may wish to adopt a funds rate constraint whose upper limit is somewhat lower than the 6-1/4 per cent of alternative C--perhaps an upper point of 5-7/8 to 6 per cent. But the timing or extent of any required tightening is likely to be affected, in current circumstances, by the potential for reaction in credit markets and by the Treasury financing. For example, the sequence of a Treasury note to be auctioned on Wednesday followed in short order by a rare, very long-term bond offering indicates that tightening should be cautious and probing in nature, but also sensitive to the opportunities presented by whatever good open space becomes available.

Mr. Coldwell observed that the Committee's constraint for the Federal funds rate applied to weekly average levels. It was his impression, however, that over the past month the Desk had tended to interpret the constraint as applying almost on a day-to-day basis. It had moved funds in and out of the market frequently by use of repurchase agreements and matched sale-purchase transactions, and it had seemed to respond to pressure on the funds rate very early in the statement week, prior to the weekend, when there was not yet much evidence to suggest where the week's average might be tending. Although he recognized that the Desk had to take account of likely future developments in its efforts to keep the weekly average funds rate within the specified limits, he thought undue sensitivity to short-run fluctuations could lead to confusion about the Committee's objectives.

In response, Mr. Holmes said the Desk did interpret the funds rate constraint in terms of weekly averages; yesterday, for example, the rate had been 5-9/16 per cent, or 1/16 of a point above the upper limit of the weekly average range specified at the last meeting of the Committee.. With respect to the heavy use of repurchase agreements and matched sale-purchase transactions, the past month had been a very difficult period for reserve management partly because errors in the System's reserve projections had been very large. Also, member banks had met an abnormally large portion of required reserves through borrowings. Just before the past weekend borrowings had run up as high as $1-1/2 billion, and net borrowed reserves in excess of $1 billion were being projected for the current statement week.

Mr. Mitchell noted that Mr. Partee's remarks about the bullishness of the economic outlook had been followed by Mr. Axilrod's report that M_1 was currently estimated to be growing at a 10.5 per cent rate in December. Together, those comments might suggest that the Committee should take some fairly drastic action to slow the growth in the money stock. However, he had already raised some questions about the outlook, and he now wished to pose a question about the money supply numbers. That was whether the adjustment to the change in Regulation J had not introduced a discontinuity into the time series for money of a kind that called for breaking the series at the point the change became effective. One possible source of discontinuity was the sudden disappearance, because of faster payment of cash letters by banks, of certain cash items in process of collection that previously had been deducted from deposit liabilities. The elimination of that subtraction item, particularly when multiplied by 12 in annual rate calculations, might have had a significant effect on the money supply series.

Mr. Axilrod replied that the staff had been collecting data from the Federal Reserve Banks in order to estimate the amount of that particular source of discontinuity in the money supply statistics. On a weekly average basis, the estimates ran between $3-1/2 billion and $5 billion, which seemed reasonable. An amount in that range was deducted from the current estimates of the money supply in order to preserve continuity with the statistics for the period before implementation of Regulation J. Later, when a historical revision was undertaken, the money supply statistics for the period both before and after implementation of Regulation J would be revised upward by similar amounts.

Mr. Mitchell remarked that another possible source of discontinuity related to changes in money management practices arising from faster settlement of checks since the revision in Regulation J. Experience with the Regional Check Processing Centers had shown that a speed-up in payments led to an increase in both corporate and personal deposit balances. Many corporate treasurers had also been utilizing float originally generated by the Federal Reserve. To the extent they had done so, the change in Regulation J would require them to hold larger cash balances.

Mr. Axilrod responded that in the staff's judgment such effects were likely to have been rather minimal. In any case, he did not believe they were a factor in the large money supply increase in the week ending December 6.

Mr. Morris commented that he had been informed by the chief money manager for a major insurance company that for years his company had maintained a negative demand deposit balance on its own books, but that because of the change in Regulation J it had had to raise its cash balance. It seemed likely that other companies also had been affected. Because the question was an important one, it might be desirable for the staff to talk informally with the treasurers of some major corporations before the next Committee meeting in an effort to learn whether there had been significant changes in cash management practices.

After discussion, it was agreed that such an inquiry should be carried out with the assistance of the Reserve Banks.

Mr. Daane referred to the three questions he had posed earlier and said that Mr. Axilrod's answer to the first--whether an effort should be made to compensate for the recent overshoot in growth rates of the aggregates--apparently was that if relatively low growth rates developed the Committee should accept them rather than seek easier money market conditions. As to how actively the Committee should press to reduce the growth rates if they did not slow of their own accord, Mr. Axilrod suggested that any tightening moves should be cautious and probing. That response raised anew his third question, concerning the meaning of the longer-run targets for the aggregates. Specifically, what would be the meaning of a 5 per cent target for M_1 if the Committee was not going to exercise the restraint necessary to achieve it? In his judgment it would be better to retain the 6 per cent target, since it was more realistic.

Continuing, Mr. Daane observed that he found the current blue book to be deficient in some respects. Alternatives B and C for the operational paragraph of the directive contained a reference to "possible credit market developments," but the blue book did not provide sufficient analysis of the meaning of that language. Similarly, all three alternatives contained a clause reading "taking account of Treasury financing operations," but there was no discussion in the blue book of the importance of even keel considerations in the period ahead.

Mr. Partee noted that the staff had not learned of the Treasury's plan for a long-term bond financing until Friday afternoon, when the blue book was in its final stage of preparation. Even then, information was not available on the specific terms and timing of the offering and as to whether or not an auction technique would be used. The staff had firm knowledge only with respect to the $2 billion issue of notes, which was a regular quarterly auction and in itself did not involve significant even keel considerations.

Mr. Daane asked whether the staff would indicate now how much weight they thought should be given to even keel considerations.

Mr. Axilrod noted that in his statement he had suggested that any tightening should be cautious and probing partly because of the forthcoming Treasury financings. However, in light of the strength of the economy and the need to hold down the rate of growth in the aggregates, he would recommend that tightening actions not be delayed very long. There would be difficult problems of timing, since the note would be auctioned on December 20 for payment on December 28 and the bond probably would be offered around the 3rd or 4th of January. He thought it would be possible to take some firming actions in advance of the bond offering.

Chairman Burns said he thought the bond offering probably would be in the form of an auction. He asked whether that offering might not have substantial effects on the whole long-term market.

Mr. Axilrod replied that the auction might go better, and the whole long-term market might adjust more smoothly, if participants had a clear notion of the direction of policy than if they were quite uncertain about the extent and timing of further pressure from monetary policy. That was one reason he had suggested moving in advance of the bond offering. Such action would, of course, result in a higher average interest cost to the Treasury, but he thought that would be a price worth paying for the sake of achieving a more stable background against which to conduct the offering. There were subtle questions of market psychology involved; if the bond was auctioned in an atmosphere of great uncertainty, the bids received might be insufficient to cover the amount of the offering, or there might be a very wide spread between the average yield and the highest yield at which the bonds were sold. Either outcome could have unfortunate consequences for the public's attitudes toward Government obligations.

Mr. Daane noted that both the blue book and the Manager today had indicated that the market had not yet adjusted fully to the firming actions that had already been taken. He asked how much of a further rise in the funds rate Mr. Axilrod had in mind.

Mr. Axilrod replied that the amount of firming feasible would depend on developments with respect to peace negotiations, the general state of the market, and other factors which could not be foretold with confidence. He would simply suggest that, within the framework of even keel considerations, the Desk seize whatever opportunities there were to allow the funds rate to rise by 1/8 of a point or so at a time.

Mr. Eastburn, referring to Mr. Coldwell's earlier remarks about the conduct of operations since the last meeting, noted that he had participated in the daily conference call during that period. Despite considerable uncertainty about the statistics, there was evidence very early in the period that the aggregates were growing at rates at or above the upper limits of the desired ranges. That was in contrast to the usual situation; ordinarily, clear indications of overshoots or shortfalls did not appear so early. Nevertheless, it was not until the end of the period that the funds rate reached the upper limit of its specified range. Had the rate been allowed to rise faster early in the period, the System's posture would have been indicated to the market more clearly, and the present problem of market uncertainty on the eve of an even keel period would have been avoided. If the funds rate could not be permitted to move faster in the circumstances of the recent period, it seemed unlikely that the full range specified would be used very often.

Chairman Burns remarked that while operations in the recent period might have been conducted differently by different people, Mr. Eastburn's comments seemed to suggest attempting a degree of fine-tuning that in his judgment was probably unattainable. The half-point increase in the funds rate since the last meeting was a substantial move, as was the net increase over the period since February, when the rate had averaged 3.29 per cent. But granting Mr. Eastburn's point for the sake of discussion, he wondered what conclusions would be implied.

Mr. Eastburn said he would suggest that over coming months the Committee keep a close watch on the responsiveness of the funds rate to overshoots and shortfalls in the aggregates. He hoped the funds rate would be found to be quite responsive. If not, however, the Committee might instruct the Desk to respond more rapidly, perhaps on the basis of less complete information about the aggregates than it now awaited. Alternatively, if the level of the funds rate was not going to be sensitive to deviations in the aggregates, the Committee might narrow the range specified for it.

Mr. Daane observed that he would concur in any suggestion for narrowing the funds rate range. He noted in that connection that a range of 5-3/8 to 6-1/4 per cent was shown in the current blue book in connection with alternative C. It was not clear to him what purpose was served by presenting such an alternative for consideration today, since a rise in the funds rate to the upper limit of 6-1/4 per cent could be expected to have highly disruptive effects on the market.

Mr. Axilrod noted that there had been some comments on the significance of the blue book ranges during the Committee's discussion of methodology at the previous meeting. Briefly, the ranges shown for the funds rate under each of the alternatives represented the staff's best estimate of the likely consequences for that rate if the Committee adopted the associated growth rates for the aggregates as targets. The Committee, of course, could always specify some different constraint on policy grounds; but in his judgment the staff would be derelict if it withheld those estimates from the members.

Chairman Burns concurred in Mr. Axilrod's observation. Turning to the question of targets for the monetary aggregates over the longer run--for the first half of 1973--the Chairman noted that he, unlike Mr. Partee, would not describe a reduction from 6 to 5 per cent in the target for M_1 as a small change. In his view, it would be a change of very great importance--one that, if continued by another such step or two, could later bring on another credit crunch, which the Committee surely was determined to do its best to avoid. If the Committee thought some reduction in the target was desirable, it might adopt a 5-1/2 per cent rate. Or perhaps it should specify the target simply as a growth rate falling within a 5 to 6 per cent range.

Mr. Brimmer expressed the view that the longer-run target should not be moved up or down from month to month. It was not clear to him that the economic outlook had changed sufficiently since the November meeting to warrant a change in the target at this time.

Mr. Hayes said it had been understood that the 6-month target would be subject to review and possible revision at each meeting. In his judgment the developments since the last meeting provided strong grounds for reexamining the target today.

Chairman Burns agreed that the longer-run target should be reexamined at each meeting. However, he also thought that any changes should be made cautiously and deliberately.

The Chairman then noted that the Committee would want to recess for luncheon unless it were able to complete its deliberations on policy rather soon. To determine how close the members were to agreement, he might suggest a particular directive and set of specifications, and ask the members to indicate whether they considered them reasonably close to their own preferences. For the operational paragraph of the directive, he would suggest alternative C of the staff's drafts; and for the longer-run target, an annual rate of growth over the first half of 1973 of 5 to 6 per cent for M_1, and corresponding rates for the other key aggregates. As to short-run ranges of tolerance for growth rates in the aggregates, he would suggest adopting the upper limits of the ranges shown under alternative C, but reducing the lower limits in each case. Specifically, the ranges for growth rates over the December-January period would be 4 to 11 per cent for RPD's, 3 to 9 per cent for M_1, and 4 to 10 per cent for M_2. Finally, for the funds rate constraint he would propose a range of 5-1/4 to 5-3/4 per cent. It might be found that those specifications were significantly inconsistent, but in that event the Committee could then consider the need for supplementary instructions.

A substantial number of members indicated that they would favor further discussion of the Chairman's proposal. Accordingly, the meeting recessed. It reconvened at 2:45 p.m., with the same attendance as at the morning session.

Mr. Brimmer noted that the Committee had agreed on a longer-run target of 6 per cent for M_1 at its November meeting, following a fresh assessment of the economic outlook in connection with a staff chart presentation. He was still not persuaded that it was desirable to modify that target so soon after it was adopted.

Chairman Burns remarked that he also was inclined to the view that a change in the target at this point might be a little premature. He had included a 5 to 6 per cent target range for M_1 among the specifications he had proposed this morning because he thought such a reduction would reflect the preference of a majority. He might note that his suggested short-run specifications for the aggregates were more restrictive than those shown under alternative C since the lower limits of the ranges would be reduced. The purpose was to keep the Desk from having to take liberalizing actions too early in the event that incoming data for the aggregates were somewhat weaker than anticipated. That seemed to be in accord with the thinking of the Committee, and he agreed that it would be appropriate policy at this juncture.

Mr. Hayes remarked that he concurred in the view that the Committee should move very cautiously in the forthcoming period of Treasury financing. Nevertheless, he wondered whether a slightly wider range for the funds rate--specifically, 5-1/8 to 5-7/8 per cent, as under alternative B--would be preferable to the range the Chairman had cited.

In response, Chairman Burns noted that the funds rate had risen by 1/2 of a percentage point in the 4 weeks since the last meeting of the Committee. Moreover, the bond financing in which the Treasury would be engaged in the period ahead was an intricate one, with potentially large implications for the long-term securities markets. It was for those reasons that he thought a funds rate range allowing for a further rise of 1/4 point would be sufficient at this time. If necessary, the Committee could reconsider the range before the scheduled date of its next meeting.

Mr. Daane remarked that he had not been enthusiastic about the specifications Chairman Burns had suggested before lunch because the ranges of tolerance for the aggregates over the December-January period were related to, and as the Chairman had said, were somewhat more restrictive than, those specified under alternative C. According to the blue book, the C specifications would be associated with substantial increases in short-term interest rates and considerable pressure on long-term markets. In view of the forthcoming Treasury financings--including an important, if seemingly small, bond offering--he would prefer to put more stress on the nature of money market conditions in the period ahead than on short-run fluctuations in the aggregates. In particular, he thought any firming actions should be of a delicate, probing nature. As to the longer-run target for M_1, like Mr. Brimmer he believed it should not be lowered from 6 per cent at this time. Even an effort to restore the longer-run growth rate to 6 per cent could exert considerable pressure in both short- and long-term markets.

Mr. Hayes commented that with respect to the funds rate--which under present circumstances he considered to be a more important element in the instructions to the Desk than were the aggregates--the range proposed by the Chairman was less restrictive than that shown under alternative C.

Mr. Daane agreed. He noted that he could accept either the range for the funds rate suggested by Chairman Burns or the slightly wider range proposed by Mr. Hayes, so long as stress was placed on even keel considerations.

Mr. MacLaury observed that in its discussion of longer-run targets for M_1 the Committee was considering a different time period from that used at the last few meetings; the longer-run target now applied to the first half of 1973 rather than to the fourth quarter of 1972 and the first quarter of 1973 combined. Accordingly, a change in the target would not necessarily represent a quick reversal of the conclusion the Committee had reached at its previous meeting, as Mr. Brimmer had implied. In any case, in view of the increasing strength in the economic outlook, he thought the target for the first half should be below 6 per cent.

Chairman Burns commented that, although the longer-term target was specified in terms of particular calendar quarters, at each meeting the members actually tended to think in terms of a period extending roughly 6 months ahead. Mr. Brimmer no doubt had had that consideration in mind; and he probably also was making a distinction between the short-run ranges of tolerance for the aggregates, which might move up or down from meeting to meeting, and the longer-run target, which should have a degree of stability. Finally, he thought Mr. Brimmer was suggesting not that a target be held to rigidly but that any change be made cautiously and deliberately. That was especially so in circumstances like the present when the existing target had been the nearly unanimous preference of the members at the previous meeting.

Mr. Brimmer agreed that Chairman Burns had interpreted his views correctly.

Mr. MacLaury then referred to the comments that had been made regarding even keel and said he agreed that the Committee would want to be cautious in any firming action, given the Treasury's prospective offering of a 20- to 30-year bond. What concerned him, however, was that the Treasury would be in the market frequently over the next several months. He wondered whether it was essential for the Treasury to proceed with the bond offering that had been announced.

Chairman Burns said he thought the Treasury unquestionably would proceed with the bond offering. The amount of the offering, within the announced range of $500 million to $750 million, was still undecided, as was the question of whether an auction technique would be used. He understood, however, that the Treasury was strongly inclined toward an auction.

Mr. Coldwell remarked that he had not favored the policy suggestion the Chairman had made before the luncheon recess because of the narrowness of the range proposed for the funds rate. If the blue book analysis was correct, a funds rate in that range would be accompanied by growth in the aggregates not at the alternative C rates but at rates between those specified for alternatives A and B. He would prefer a funds rate range of 5 to 6 per cent, although he would hope that the rate would not go as high as 6 per cent unless the behavior of the aggregates made that absolutely necessary.

In response to the Chairman's question, Mr. Coldwell said he would not be disturbed by a further rise of 1/2 of a percentage point in the funds rate--even following the rise of 1/2 of a point over the past 4 weeks--if that was necessary to keep the growth rates in the aggregates from exceeding the upper limits specified for them.

Chairman Burns observed that there was little difference between Mr. Coldwell's suggestion for a 6 per cent ceiling for the funds rate range and his own suggestion that the ceiling be set at 5-3/4 per cent with the understanding that the Committee would reconsider its instructions if significant inconsistencies developed.

Mr. Coldwell agreed that there was not a great deal of difference between the two formulations, given the understanding the Chairman had mentioned.

Chairman Burns observed that such an understanding had been an element of the Committee's procedures since February. Of course, some room for judgment was needed with regard to the importance of any inconsistences that might develop.

Mr. Holmes asked whether, from an operating point of view, any significance should be attached to the effect on the mid-points of the ranges of tolerance for growth rates in the aggregates resulting from the reduction in the lower limits of those ranges in the specifications proposed by the Chairman.

Chairman Burns expressed the view that no significance whatever should be attached to the mid-points of the ranges. As had been agreed at a recent meeting, the objective for the weekly average funds rate would remain unchanged until the growth rates approached the upper or lower limits of their ranges--and then it would be modified by no more than 1/8 of a point unless those limits were breached.

Mr. Robertson observed that the economic situation clearly indicated that policy should move in a restrictive direction; the only issue was one of degree. For the longer run, he thought the target for M_1 should be below 6 per cent, and the range of 5 to 6 per cent was acceptable to him. The language of alternative C also was acceptable, and so were the suggested short-run ranges for RPD's, M_1, and M_2. There appeared to be little chance that rates of growth would fall into the lower parts of those ranges, but if that did occur it should not occasion any easing actions.

If he had any problem with the proposed specifications, Mr. Robertson continued, it was with the range for the funds rate; personally, he would prefer an upper limit higher than 5-3/4 per cent. In view of the prevailing economic outlook he thought that even keel should be given the minimum consideration feasible and that allowance should be made for as much firming as was possible under the circumstances. It appeared, however, that the amount of firming that would prove feasible was not very great. Consequently, he did not attach great importance to the differences in the several upper limits that had been suggested for the funds rate.

Mr. Mitchell said that either a 5-3/4 or 5-7/8 per cent upper limit for the Federal funds rate constraint would be acceptable to him. However, he considered the short-run specifications the Chairman had proposed for the aggregates to be unrealistic; it was quite likely that a funds rate in the suggested range would be associated with short-run aggregate growth rates in excess of the upper limits the Chairman had mentioned. That would not greatly disturb him, partly because he thought the significance of the aggregates would be reduced for a time by the continuing effects of the change in Regulation J, and partly because the average growth rate in M_1 had been relatively low over the past 4 months. Moreover, it should be recognized that the Committee was operating under an interest rate constraint at this time. For those reasons, he thought the members should be prepared to accept rather large increases in M_1 and RPD's temporarily, without feeling that they had to take actions which would result in vigorous movements in interest rates.

Mr. MacLaury commented that while the M_1 growth rate had been relatively low over the past 4 months, that was not the case when longer periods were considered. Thus, the growth rate had been 8.5 per cent over the third quarter; it was presently estimated at 7.0 per cent in the fourth quarter, and might be found to be still higher after the revisions in the seasonal factors were completed.

Chairman Burns observed that M_1 had grown at an annual rate of 6 per cent over the 2 years ending in December 1971, 7 per cent over the 12 months ending in November 1972, 6.9 per cent over the 6 months ending in November, 5.2 per cent over the 3 months ending in November, and 6.4 per cent in the month from October to November. That was a record of moderation, and it was generally recognized as such, abroad as well as at home. Moreover, from the third quarter of 1971 to the third quarter of this year, the narrowly defined money supply had grown less than real GNP: in that period, M_1 had risen about 6 per cent while real GNP had risen about 7 per cent. The current dollar value of GNP had grown about 10 per cent. The concern about the rate of monetary growth had been generated mainly by the figures for the first week of December and by a projection that the rate of growth would be 10 per cent for the month as a whole. With economic activity expanding briskly, a little more restraint was now in order, but figures for an individual week or month should not be allowed to provoke an overreaction.

Mr. Heflin remarked that he agreed with the statement that had been made by Mr. Robertson. Specifically, some additional monetary restraint was needed but even keel considerations imposed constraints on the degree, and the rates of growth for the aggregates that resulted would not necessarily be the desired rates.

He would favor the language of alternative C, a longer-run target for the M_1 growth rate in a range of 5 to 6 per cent, and given the existing constraints, a Federal funds rate range of 5-1/4 to 5-3/4 per cent.

Mr. Sheehan commented that in his view the large rise in retail sales in December and the rapid growth in GNP in the fourth quarter were mitigating factors with respect to the relatively high rate of monetary expansion indicated for the fourth quarter. Over the past 4 weeks, the Federal funds rate had risen a full 1/2 of a percentage point, and he would not want to see the rate rise above 5-3/4 during the next 4 weeks.

In response to questions by Mr. Mitchell, Mr. Holmes said the payment date for the Treasury's long-term bond probably would be January 10, and the duration of the even keel period would depend on how well the bond had been distributed by that date. If the growth rates of the aggregates appeared to be well within their specified ranges during the even keel period, the Desk would try to maintain stable money market and reserve conditions. On the other hand, if the aggregates appeared to be very strong, the Desk would allow the funds rate to move toward the upper end of its range, to the extent that could be done without jeopardizing the success of the financing. During the period, long-term markets would be affected by many influences--such as peace negotiations and developments with respect to the Federal budget--as well as by System operations. The more favorable those other influences were, the greater would be the potential for restrictive actions by the System within the framework of even keel. If circumstances were very favorable, it should be possible to permit the funds rate to rise as high as 5-3/4 per cent during the even keel period.

Chairman Burns then suggested that the members indicate their preferences between longer-run targets indexed by M_1 growth rates of 6 per cent, and 5 to 6 per cent, over the first half of 1973.

A majority of members expressed a preference for a 5 to 6 per cent target growth rate.

The Chairman asked for an expression of preferences with respect to the Federal funds constraint, as between ranges of 5-1/4 to 5-3/4 and 5-1/8 to 5-7/8 per cent.

A majority indicated that they favored the latter range.

The Chairman asked whether there was any objection to adopting alternative C for the operational paragraph of the directive, and none was heard.

Mr. Holland noted that in the directive drafts distributed by the staff no changes were proposed in the statement of general policy, contained in the third paragraph, if the Committee adopted alternative A or B for the operational paragraph. However, a revision of the statement of general policy was suggested in connection with alternative C.

It was decided that the statement of general policy previously used, as shown under alternatives A and B, should be employed.

After further discussion, the Chairman proposed that the Committee vote on a directive consisting of the staff's drafts of the two general paragraphs, a third paragraph containing the previously employed statement of general policy, and alternative C for the operational paragraph. It would be understood that that directive would be interpreted in accordance with the following specifications: longer-run targets for the aggregates indexed by an annual rate of growth of 5 to 6 per cent for M_1 over the first half of 1973; short-run ranges of tolerance for growth rates over the December-January period of 4 to 11 per cent for RPD's, 3 to 9 per cent for M_1, and 4 to 10 per cent for M_2; and a Federal funds rate constraint for statement weeks in the period until the next meeting of 5-1/8 to 5-7/8 per cent. It would also be understood that if significant inconsistencies appeared to be developing among the Committee's various instructions, the Manager was promptly to notify the Chairman, who would then promptly decide whether the situation called for special Committee action to give supplementary instructions.

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 strong recent gains in 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. The unemployment rate has declined. Wage rates increased little in November, following 2 months of large increases. Consumer prices rose considerably again in October, and wholesale prices rose sharply in November. The over-all deficit in the U.S. balance of payments has remained substantial in recent months, but there has been a moderate reduction in the excess of U.S. merchandise imports over exports since last spring and summer.

In November rates of growth in the monetary aggregates generally remained moderate, but expansion in the narrowly defined money stock quickened in early December. In recent weeks most market interest rates have tended upward.

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 Treasury financing operations and possible credit market developments, the Committee seeks to achieve bank reserve and money market conditions that will support slower growth in monetary aggregates over the months ahead than appears indicated for the second half of this year.

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.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, January 16, 1973, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

December 18, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on December 19, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting, including strong recent gains in 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. The unemployment rate has declined. Wage rates increased little in November, following 2 months of large increases. Consumer prices rose considerably again in October, and wholesale prices rose sharply in November. The over-all deficit in the U.S. balance of payments has remained substantial in recent months, but there has been a moderate reduction in the excess of U.S. merchandise imports over exports since last spring and summer.

In November rates of growth in the monetary aggregates generally remained moderate, but expansion in the narrowly defined money stock quickened in early December. In recent weeks most market interest rates have tended upward.

STATEMENT OF GENERAL POLICY AND OPERATIONAL PARAGRAPHS

Alternative A

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 Treasury financing operations, the Committee seeks to achieve bank reserve and money market conditions that will support growth in monetary aggregates over the months ahead at about the rates that appear indicated for the second half of this year.

Alternative B

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 Treasury financing operations and possible credit market developments, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead.

Alternative C

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions that will resist intensification of inflationary pressures while promoting sustainable growth in real output and employment and progress toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of Treasury financing operations and possible credit market developments, the Committee seeks to achieve bank reserve and money market conditions that will support slower growth in monetary aggregates over the months ahead than appears indicated for the second half of this year.

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

December 19, 1972

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 12/19/72)
A. Longer-run targets (SAAR): (first and second quarters combined)	M_1	5 - 6%
	M_2	5 - 6%
	Proxy	5 - 6%
	RPD's	5 - 6%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (December-January average):		4 - 11%
2. Ranges of tolerance for monetary aggregates (December-January average):	M_1	3 - 9%
	M_2	4 - 10%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		5-1/8 - 5-7/8%
4. Federal funds rate to be moved in an orderly way within range of toleration		
5. Other considerations: account to be taken of Treasury financings and credit market developments.		

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