MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday and Tuesday, January 21-22, 1974, beginning at 8:15 p.m. on Monday.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Balles
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Francis
Mr. Holland
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Sheehan

Messrs. Clay, Eastburn, Kimbrel, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Black, MacLaury, and Coldwell, Presidents of the Federal Reserve Banks of Richmond, Minneapolis, and Dallas, respectively

Mr. Broida, Secretary
Mr. Altmann, Assistant Secretary
Mr. Partee, Senior Economist
Mr. Bryant, Associate Economist
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Managing Director for Operations and Supervision, Board of Directors
Messrs. Cardon and Coyne, Assistants to the Board of Governors

Chairman Burns observed that he had called for this evening's session in order to permit the Committee to hear reports on the several foreign meetings recently attended by System people without infringing on the time available tomorrow for deliberations on other matters on the agenda. He invited Mr. Bucher to report on his recent visit to the Philippines on the occasion of the 25th anniversary of that country's central bank and the dedication of their new central bank building.

Mr. Bucher said he would comment briefly on some of his impressions regarding the political and economic situation in the Philippines. As the members would recall, in September 1972 President Marcos had declared martial law and dissolved the legislature; since that time he had been ruling as what amounted to a benevolent dictator. Most of the people with whom he (Mr. Bucher) had discussed the matter, including a number in the American community, approved the President's 1972 action and the manner in which he subsequently had been governing the country; it was their feeling that the country's democratic institutions had not been working and that a fresh start was needed. Apparently, before the imposition of martial law there had been a number of independent armies in the country, and a great deal of violence and anarchy. Substantial progress seemed to have been made in dealing

with that problem; for the time being, at least, the violence had almost disappeared. The authorities had confiscated about one-half million weapons, and while substantial numbers of arms apparently remained in private hands, the confiscations had had a major impact. The only people he had seen carrying weapons were military policemen, and he understood that was quite different from the situation before September 1972. Violence was still a problem in the southern part of Mindanao, mainly because of frictions between Moslems and Christians in that area.

One of the prevailing attitudes in the Philippines, Mr. Bucher continued, was that there had been a great improvement in the country's image of itself. There also was a strong determination to develop a national identity, to overcome the identity problem from which the Philippines suffered as a result of their long occupation, primarily by the Spanish and the Americans. In that connection, efforts were being made to develop the local dialect called "Tagalog" into a national language in place of English. The government had introduced a number of popular measures, including land reform, and it had undertaken various public works projects in southern Mindanao in an effort to appease the Moslem population there.

However, Mr. Bucher remarked, the country was still basically a dictatorship with the potential problems that one could expect to develop under such a form of government. While the people seemed optimistic that President Marcos at some point would make good on his promise to reinstate democratic institutions, one could not help but wonder how quickly any person would give up the kind of power the President now possessed. Still, the majority appeared to be convinced that for the time being his rule was the best thing for the country, as evidenced by the quiet acceptance of the expiration of his constitutional term as President late last year.

Mr. Bucher remarked that, although the Philippines faced many economic problems, there were indications that some progress was being made in that area also. The output of agricultural products, particularly rice, had been reduced by the typhoons of a few years ago and, to a lesser extent, by those of last year; for a period the country--normally a rice exporter--had become an importer. That, of course, did not help their balance of payments problem. Recently, however, their merchandise trade balance had improved. They were, of course, worried about the effects of the rise in oil prices on the cost of imports, but at the same time their trade balance was benefiting from the higher prices of the

raw materials they exported. The absence of oil in the country had been a matter of concern even before the energy crisis developed. With the encouragement of the government, some oil companies were carrying out exploration work off the southern tip of Mindanao, but as yet they had made no significant discoveries. Japan was now their largest trading partner, having passed the United States about a year ago. However, there was some doubt whether Japan would continue in that position; in particular, there was concern about a possible reduction in Japan's imports of raw materials from the Islands. He might note, incidentally, that Prime Minister Tanaka of Japan had arrived in the Philippines on the last day of his (Mr. Bucher's) visit. Unlike the situation when the Prime Minister visited some other Southeast Asian countries, his arrival in the Philippines was not marked by anti-Japanese demonstrations.

Mr. Bucher observed that President Marcos had launched programs in three areas which were designed to increase foreign participation in the Philippine economy. One program was directed at promoting further development of their extractive industries, and another was aimed at encouraging expansion of manufacturing. It was hoped that the prevailing wage rates in the Islands, which on the average were quite a bit lower than in Taiwan, South Korea,

and Hong Kong, would attract companies that might otherwise locate manufacturing facilities in such countries. The third program was in the financial area. An effort was being made to encourage U.S., Japanese, and other foreign banks to invest in existing Philippine commercial banks, up to a limit of 40 per cent of the capital of the latter. The object was to permit local banks to finance a larger proportion of domestic economic activity.

In concluding, Mr. Bucher observed that the Philippine government faced liquidity problems; most of its direct and indirect debt, in public and quasi-public form, was in short-term obligations. Notwithstanding that situation, however, the central bank had been able to finance and construct a beautiful group of buildings of monumental proportions to house its activities.

Chairman Burns invited Mr. Brimmer to report on the Conference on World Banking in London, from which he had just returned. The Chairman noted that copies of the paper Mr. Brimmer had presented at the Conference had been distributed to Committee members.

Mr. Brimmer remarked that the Conference, which was held over a three-day period, was sponsored primarily by a number of financial publications, mostly British but including one American publication. The 400-odd participants came from many parts of the

world, including Eastern Europe, Africa, the Middle East, and former British colonies in the Caribbean. The proceedings were dominated by the oil question. The program had been revamped late in the planning stage to include two sessions dealing explicitly with that question and with the ways in which the oil-producing countries might want to invest their enlarged flow of funds. However, the tone of the whole meeting was set on the opening day, when the first speaker began to talk about the role of the International Monetary Fund and promptly got into a discussion of the oil issue. Of the 24 prepared papers, his (Mr. Brimmer's) was one of the few that were not directly concerned with oil.

On the whole, Mr. Brimmer observed, the positions were advanced with a great deal of vigor. In one paper, a Lebanese asserted that the Western countries had had the upper hand for years but that the turn of the developing countries had now come; he advised the West to accept the fact that raw materials were now more expensive and to devote its energies to deciding how to handle the associated change in flows of funds. The respondent to that speaker took issue not with his forecast of the demand and supply for oil but with his position on how the flow of funds should be managed. The problems posed for developing countries were raised only peripherally at the Conference--and mainly during

the question periods. It was agreed that those problems were severe, but no suggestions for resolving them were offered. Former Under Secretary of the Treasury Roosa presented a paper on international monetary reform. The Governor of the Bank of England, on the first day of the Conference, talked about the outlook for the British balance of payments. Among other things, the Governor indicated that--even apart from the oil crisis--Britain was on the verge of incurring a substantial deficit in its payments balance, and that belt-tightening consequently was called for. That statement was mildly challenged on the last day of the Conference by the former Governor of the Bank of England. The present Governor's remarks also got caught up in the continuing vigorous domestic political debate over Britain's economic situation.

While in London, Mr. Brimmer continued, he had spent some time in conversations at the Bank of England and in the City, and in discussions with the economic staff at the U.S. Embassy. A central theme emerging from those conversations, although stated with varying degrees of assurance, was that prospects--as seen in late October and early November, before the development of the oil crisis--had been for a world-wide recession. The crisis had simply aggravated the problem. At the Bank of England, he had

asked various officials for their assessment of the likelihood that Britain or other industrial countries would have to borrow from the IMF. The responses suggested that, while Britain would have to borrow a substantial volume of funds in 1974, it would be reluctant to approach the IMF and would look to the Euro-dollar and U.S. markets instead.

Mr. Brimmer said he had been particularly interested in a suggestion made at the Conference that the Arab countries should organize a new currency system involving a "Middle East dinar," which would be issued by an Arab financial institution and used as the basis for denominating transactions in petroleum. While that idea was new to him, he learned at the Bank of England and in the City that some merchant bankers had been looking into its possibilities. It was generally agreed, however, that in the short run the oil-producing countries would have to rely on traditional channels to invest their funds, particularly on the money markets of Britain and the United States, although funds coming to this country might follow an indirect route designed to conceal their source.

The Chairman invited Mr. Daane to report on the January Basle meeting, which he and Mr. Hayes had attended.

Mr. Daane said the discussion at Basle centered on the "monetary fall-out of the oil crisis," to use President Zjilstra's term, and on the question of the kinds of intervention policies that central banks should be following. One point made was that the problem should be faced multilaterally--that it should not be dealt with by unilateral exchange rate actions which could degenerate into competitive devaluations. The U.S. delegation urged intervention on a sizable scale, particularly by the Germans, in order to prevent an unduly rapid appreciation of the dollar. There was considerable sentiment for a view expressed by President Zjilstra that it was necessary to determine the appropriate exchange rates before intervening, in order to know what rate levels to aim for.

In his own comments, Mr. Daane continued, he had noted that dollar intervention would help deal with disorderly conditions in the exchange market--on the day of the meeting the market was in a state that could be described as disorderly--and that it would reduce the dollar overhang problem about which there had been so much discussion earlier. While the central bankers were sympathetic to his point regarding disorderly markets, they argued that the overhang problem no longer existed; that they

needed their dollar holdings because they could not predict the amounts they would require to pay for oil imports. The Germans argued that intervention had to be two-sided; they asserted that they had intervened in size and were awaiting corresponding action by the United States. The U.S. representatives responded that this country had been intervening earlier and had stopped doing so only when Germany stopped. The Germans also argued that intervention had to be limited to avoid upsetting the "snake," and they offered specific assurances to the French that they would not intervene on a scale that would have that result.

Among the other points made at the meeting, Mr. Daane observed, was that the present official price of gold was completely unrealistic and that transactions among central banks should be undertaken at a higher price. It was argued in that connection that all reserve assets, including gold, had to be mobilized in the atmosphere created by the oil crisis. The need to consider ways of financing oil payments was noted, and it was suggested that the BIS could play a useful role not only with respect to financing payments but also in channeling funds from the oil-producing countries.

With respect to comments at the meeting regarding attitudes of individual countries, Mr. Daane said those made by the French and British were of particular interest. The French representative remarked that his country was adopting a wait-and-see posture, and that he had no idea what course it might follow. The British representative said the oil problem ranked only third in importance among the factors responsible for Britain's current economic difficulties; of greater importance were the labor disputes related to miners' overtime work and trainmen's work rules. He advised the group that a 3-day workweek had been adopted in Britain in a genuine effort to conserve fuel, and not for the purpose of precipitating a confrontation with labor.

In response to the Chairman's request for supplementary comments on the Basle meeting, Mr. Hayes said he had only a few points to add. The reluctance to contemplate large-scale dollar intervention was quite general, and the French specifically concurred in the German comment that intervention on a sizable scale would upset the snake. He was sorry to hear the German representative express the view that the U.S. Treasury had reverted to a policy of "benign neglect." Finally, he might note that, for the most part, the central bankers present indicated that their countries were rather firmly wedded to restrictive internal policies.

Chairman Burns said he would offer a few comments on the Rome meeting of the Committee of Twenty from which he had just returned and then ask Mr. Daane and Mr. Bryant, who also had attended the meeting, to supplement his remarks. He would speak first of the achievements at the meeting.

The Chairman noted that the plan for the meeting had called for discussion of two problems: how the structure of the International Monetary Fund might be strengthened; and how the value of SDR's might best be defined and what rate of interest should be attached to them. The members of the U.S. delegation agreed that such an agenda no longer suited the needs of the times, since nearly everyone present would be more concerned about the oil problem, and they persuaded the conference authorities not only to add that problem to the agenda but to make it the first item. As a result, there was a long and spirited discussion of the energy crisis and its financial implications. In private discussions before the formal meeting began, the U.S. representatives focused on the magnitude of the over-all problem and on its impact on the less developed countries--for example, India, the Philippines, and Turkey. At the meeting itself, Secretary Shultz cited estimates indicating that the revenues of the oil-producing countries in 1974 could rise by an amount on the order of $50 billion to $75 billion.

He stated firmly that the problem of financing flows of that magnitude was literally unmanageable, and that the magnitude of the flows therefore had to be scaled down. That meant, as the U.S. representatives said explicitly, that the price of oil had to come down.

Chairman Burns observed that there was a good deal of support for that position, not only from industrial nations but also from some of the less developed countries, notably India and Mexico. The discussion stirred up a great deal of interest; it certainly helped the less developed countries appreciate the dimensions of the problem; and it probably helped the oil-producing countries understand more clearly than they had the magnitude of the financial forces they had unleashed. That was a useful achievement, and it should assist in preparing the ground for the energy conference the President had called for February 11. In his (the Chairman's) judgment, the character of that conference would be improved because of the preparatory work the U.S. delegation had done in Rome.

A second achievement of the Rome meeting, the Chairman continued, was the decision to complete the final report of C-20 by July 31, 1974, as agreed last year in Nairobi, at which time the C-20 would go out of existence. The final report would call

for strengthening the International Monetary Fund by establishing a new Ministerial Council that would conduct surveillance of the financial policies and balance of payments policies of individual countries around the world. The report would deal with principles of a new adjustment process which, it was hoped, would be put in operation rather promptly after the Ministerial group was set up. It would convey understandings reached with regard to the valuation of SDR's and the rate of interest on them. The final report would also have something to say on principles of convertibility. But it would not attempt to resolve the gold problem; the question of the timing of a return to convertibility, and associated details, would be left to the future. The report would, however, attempt to set forth general rules for intervention in exchange markets that countries with floating currencies would be expected to observe under the surveillance of the new Ministerial group.

Chairman Burns remarked that further evolution of the world's monetary system and further reform would be expected to occur gradually over time under the sponsorship of the Ministerial group. In his view, that was a realistic way of dealing with the problem of monetary reform. It would, of course, have been desirable to launch a new monetary system if that were feasible, but it was not. Instead, progress will have to be made by steps--recognizing political

realities and recognizing also the evolution of the monetary system that was under way.

The Chairman observed that he would have nothing more to say about achievements at the C-20 meeting, although Mr. Bryant might want to comment on the partial agreement regarding SDR's that was reached. He would, however, comment on the failures at the meeting, which to his mind were no less impressive than the achievements. While there was no discussion of the intervention problem as such in the formal sessions, there were extensive private and small-group discussions. He found the position taken by the Europeans in those discussions disappointing. During the last year, the Japanese had set a fine example of constructive financial behavior. Having accumulated enormous reserves of dollars earlier, recognizing that their reserves were now excessive, and recognizing that the maldistribution of reserves required correction, the Japanese took large-scale measures designed to reduce their dollar holdings. As a result of their own deliberate actions, they had lost perhaps $8 billion of reserves since March 1973. He thought the Japanese deserved credit for what they had done.

He could not say the same for the Germans, Chairman Burns continued. The Germans have apparently been unwilling to part with

any significant part of their dollar holdings, for a number of reasons. First, they felt that they had made an investment in dollars. Since in recent months the dollar had been appreciating, they were reluctant to part with an appreciating asset. Such reasoning is, of course, appropriate for a private banker, but questionable for a central bank. A second consideration in the Germans' unwillingness to part with dollars on a significant scale was the new uncertainty introduced by the oil problem; they expected a large deficit on current account, and thought they might need the dollars to finance that deficit. A third consideration was their feeling that they had gained political prestige and power by adding $25 billion or so to their dollar holdings and raising their total reserves to the neighborhood of $30 or $32 billion--far more than any other country in the world. They seem to believe that they would be able to retain that newly-won prestige by retaining those reserves. A fourth consideration, of course, was the one mentioned by Messrs. Daane and Hayes--concern about the stability of the arrangements under the snake. That was a sound argument--but only up to a point, because the difficulties of the snake could be dealt with by a revaluation of the mark. The reluctance of the Germans to accept the principle that their excessive reserves should be brought down was disappointing to him (the

Chairman) because it had been generally agreed in the discussions of the new adjustment process--both by the Americans who had stressed the use of objective indicators and by the Europeans who had stressed the consultative process--that reserves would neither be built up persistently nor depleted persistently. But if every country was going to seek to retain whatever reserves it had accumulated, the disturbing implication was unavoidable that all of the talk about a new adjustment process was just rhetoric.

A second failure, the Chairman continued, was the action taken by France after the close of the C-20 meeting. If the example set by France were followed by other countries, the result could be economic and political difficulty around the world. The longer-run consequences that some observers had feared at the time of the 1971 suspension of convertibility may be coming to the fore. The sense of discipline that countries once had--the reluctance to devalue quickly, the willingness to defend a currency stubbornly up to a point--all that, he thought, had changed. Not too many months ago the British devalued their currency earlier than the facts available then had justified, although in view of later events their action could not be criticized. True, the French had recently lost some of their reserves, but they were unwilling to wait a while longer

to see their position tested by the market. By deciding to withdraw from the snake they had decided, in effect, to devalue the franc; that conclusion was confirmed by the subsequent decline of the franc in the exchange market. While their action was taken after the close of the C-20 meeting, he thought the timing may not be accidental. In any case, the two events would probably be linked by financial and political observers around the world. Those observers may conclude, with at least partial justification, that because very little was achieved at the meeting the French had no choice but to go their own way.

Finally, Chairman Burns observed, he might say a word about the implications for the United States, as he saw them. The recent appreciation of the dollar had proceeded faster than most observers had anticipated, and it might go further than one would like. The so-called "third devaluation" of mid-1973 had already been nullified, as had--practically speaking--the second devaluation of February 1973 as well. The first devaluation, that involved in the Smithsonian arrangement of December 1971, might soon be in process of nullification. While it was true that the appreciation of the dollar may again raise problems for the U S. balance of trade and over-all balance of payments in the future, it was also true that the appreciation would now help the United States in

its fight against inflation, and it might help significantly. It would be a great mistake for the United States to pursue extremely conservative fiscal and monetary policies under current circumstances. If, however, it pursued fairly conservative policies, the country could find itself by mid-year or towards the end of the year further along toward restoring some semblance of price stability than most other countries, and further along than most people now thought likely. The appreciation of the dollar offered an opportunity which, with a reasonable degree of luck, might be turned to good advantage. In any event, if one were looking for the silver lining that was one place to seek it.

The Chairman then asked Mr. Daane whether he had any supplementary comments.

Mr. Daane said he might note that the Deputies of the C-20 had met on January 14 and 15, shortly before the C-20 meeting itself. The Deputies had focused on the two questions which had originally been on the agenda for the C-20 meeting, concerning means for strengthening the IMF and means for valuing SDR's. He would add only two points to the Chairman's report on the C-20 meeting. First, the Managing Director of the IMF had put forward a proposal for a supplementary financing facility in the

Fund. That proposal was welcomed by many of the developing countries as a device for tiding them over the immediate problems produced by the oil crisis. The U.S. representatives expressed certain reservations, however, and in the communique issued at the end of the meeting it was noted that such a facility could, at best, be only a partial answer for the developing countries. Secondly, there was a consensus at the meeting that in a world of floating currencies it would be desirable to value SDR's in terms of the value of a basket of currencies.

Chairman Burns said he might add a word on the financing instrumentality that had been proposed by the Managing Director of the Fund. As Mr. Daane had indicated, that proposal was welcomed by the less developed countries, and also by others. While the United States endorsed the proposal, it did so with significant reservations. There were two reasons for those reservations. First, it was important that everyone at the meeting recognize that the financial problem that now appeared to face the world was simply unmanageable, and that some readjustment of oil prices was therefore essential. The recent spectacular price increases constituted an abuse of economic power that would cause damage to countries around the world, ultimately including the oil-producing countries themselves; to discuss financial mechanisms on the assumption that those prices would be main-

tained--or perhaps even raised further--would amount to a passive adjustment to an action that should be viewed as unacceptable. In short, the oil price problem had to be scaled down to manageable proportions--under the best of circumstances it would be of gigantic proportions--before efforts to devise financial mechanisms for dealing with it could succeed.

Secondly, the Chairman continued, the U.S. representatives felt that the Managing Director's proposal had to be thought through carefully. There was as yet no indication that he had received assurances from the oil-producing countries that they would make significant sums available to the IMF. Even if they were to do so, however, their terms might include, besides an exchange rate guaranty, a rate of return at least equal to market rates of interest. The IMF would lend those funds to needy countries, many of which would not be in a position to repay the loans or even to meet the interest charges. Since the IMF could not function as an eleemosynary institution, other countries--perhaps the United States and a few other industrial countries, or perhaps the United States primarily--would have to provide the funds to make good on the financial commitments to the oil-producing countries. While the U.S. representatives did not go into such detail at the meeting, they did indicate the general nature of the reasoning which led them to conclude that more careful study of the proposal was necessary.

The Chairman added that another consideration noted in discussions within the U.S. delegation was the possibility of utilizing instrumentalities other than the IMF, such as the World Bank, the Bank for International Settlements, and the System's own swap arrangements. With respect to the swap arrangements, he might mention that he planned to make a recommendation regarding them at tomorrow's session of the Committee.

Chairman Burns then asked Mr. Bryant to comment on the outcome of the discussion in Rome regarding SDR's.

Mr. Bryant said he might note simply that four different proposals had been advanced for valuing SDR's over the longer run in a reformed monetary system, each of which was held to have advantages and disadvantages. The decision at Rome essentially was to refer to the Executive Board of the IMF the problem of defining a valuation technique to be used in the interim period before a choice was made among the four alternatives for the longer run. He would be happy to comment on the technical characteristics of those four alternatives if the Committee desired, but in the interest of saving time this evening it might be preferable to leave such commentary for a later date or for a written memorandum.

Chairman Burns noted that no agreement was reached in Rome regarding the appropriate interest rate on SDR's. Most of the delegations appeared to believe that the interest rate should be approximately equal to the average rate on short-term instruments in a dozen or so major financial markets. The U.S. delegation took the position that the rate should be low.

While on that subject, the Chairman continued, he would make a personal confession: he had neglected the problem of the appropriate yield on SDR's. Mr. Bryant, who was opposed to the U.S. position as formulated by the Treasury Department, had been trying to interest him in the matter, but he had not found the time to concern himself with it seriously. Nevertheless, he had done a little thinking on the subject and had tentatively reached the conclusion that the Treasury position required reexamination. That position was based on the assumption that the United States would bear the main burden of interest charges on SDR's. However, in the kind of world that might be emerging--that is, one in which the dollar remained strong--the United States might well be on the receiving end rather than the paying end of SDR interest charges. Given the uncertainty on that score, he now thought the United States should probably propose a formula that would yield an intermediate interest rate on SDR's. The specific formula he

had in mind was that the rate might be equal to the lower of two figures: 5 per cent, or the average interest rate in a dozen or so major financial markets less 2 percentage points. He intended to recommend that proposal to the Treasury, unless the staff--to whom it probably came as a surprise tonight--persuaded him that it was mistaken.

Mr. Daane remarked that, whether or not the Chairman's proposal had surprised the staff, it certainly had surprised him. He agreed that the Treasury's preference for a low rate on SDR's was based principally on an assumption regarding the probable incidence of the interest burden. He shared the Treasury's preference, but for a different reason. His position was based on the view that it was inherently wrong for reserve assets to yield a high rate of return, since that would offer central banks a motive for holding them beyond their need for reserves. If an asset was to function as an international money, its yield should be low; gold was a good example of an asset which had performed that function effectively while yielding no interest return at all.

Chairman Burns commented that he would describe the interest rates yielded by his formula as intermediate rather than high. With respect to SDR's themselves--and this comment might also come as a surprise--the more he thought about them, the more skeptical he

became about their role in a future monetary system. He recognized the arguments in favor of SDR's and considered them worthy of respect. However, SDR's had one feature that already was causing trouble and that might cause more serious trouble in the future. SDR's were printing press money; they were created on international printing presses, and distributed without charge to the countries of the world. When reserves were created at no cost to anyone, it was natural for the poor countries to ask that they be distributed in a way that helped meet their special needs. Such an argument had already been advanced, in connection with the so-called "link," and he found that troubling. To have money created by an international printing press in addition to domestic printing presses was not a happy prospect. Moreover, the international practice was bound to have some influence on domestic practice. If international money could be created and distributed in a way that favored poor countries, why could not domestic money be created for distribution to the poor? Such proposals already were frequently advanced, and he thought they would be encouraged by SDR's.

The Chairman added that no decisions regarding SDR's were likely to be taken for some time, even if agreements were reached soon regarding the valuation procedure and the interest return. In

the interim, events might move the international monetary system in a different direction.

Mr. Daane remarked that he shared the Chairman's concern about the risks, in terms of pressures from the LDC's, involved in creating SDR's. But SDR's still seemed to him the preferable--both equitable and controllable--way to meet the secular need for reserves. And it seemed to him that the pressures from less-developed countries which could conceivably add to and hold reserves to have newly created SDR's channeled in their direction could be greater the higher their rate of return. He might have no objection to the formula the Chairman had suggested for determining the rate on SDR's if he thought it would be held to, since the maximum would then be 5 per cent. However, what concerned him was the possibility that once an average of market rates was accepted as an element in determining the return on SDR's, it would become the primary element. It was likely that the actual formula that would emerge would call simply for a return on SDR's of 1 or 2 percentage points below the average market rate, which recently would have meant a rate close to 10 per cent.

Chairman Burns observed that from private conversations he had reason to believe that a 5 per cent rate on SDR's would be negotiable. If that was true, the formula he had described also was likely to be negotiable.

Mr. Daane said he might add one historical note. In 1964 he had been among a small minority within the U.S. Government who advocated a low interest rate on SDR's. The majority, who favored a high rate, were firmly convinced that eventually all of the SDR's would "come home to roost" in the United States. While they might eventually do so, ten years had passed and they had not done so yet.

Thereupon the meeting recessed until 9:30 a.m. the following morning, Tuesday, January 22, 1974. Committee attendance was the same as on Monday evening. Staff attendance was the same as on Monday except that Mr. Cardon was absent, and the following were present:

Mr. O'Connell, General Counsel
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Andersen, Eisenmenger, Gramley, Reynolds, Scheld, and Sims, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Pierce, Associate Director, Division of Research and Statistics, Board of Governors
Mr. McWhirter,[1/] Associate Director, Division of Federal Reserve Bank Operations, Board of Governors
Messrs. Keir, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mr. Ettin, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Assistant Adviser, Division of Research and Statistics, Board of Governors
Miss Pruitt, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Mr. Doll, Senior Vice President, Federal Reserve Bank of Kansas City

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1/ Entered meeting at point indicated.

Messrs. Brandt, Davis, Hocter, and Nelson, Vice Presidents, Federal Reserve Banks of Atlanta, New York, Cleveland, and Minneapolis, respectively
Mr. Kaminow, Economic Adviser, Federal Reserve Bank of Philadelphia
Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York
Messrs. Broaddus and Pardee, Assistant Vice Presidents, Federal Reserve Banks of Richmond and New York, respectively

Chairman Burns noted that Mr. Daane's period of service as a member of the Committee was drawing to a close, since his term as a member of the Board of Governors would soon be ending. Mr. Daane's contributions to the work of the Committee would be missed, but it was to be hoped that the members would continue to see a great deal of him in other capacities. A luncheon in Mr. Daane's honor was planned for the day of the next FOMC meeting, February 20, 1974.

By unanimous vote, the action of Committee members on January 4, 1974, increasing from $2 billion to $3 billion the limit specified in paragraph 1(a) of the authorization for domestic open market operations on net changes between Committee meetings on System Account holdings of securities, effective January 4, 1974, through the close of business on January 22, 1974, was ratified.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on December 17-18, 1974, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on December 17-18, 1974, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period December 18 through January 16, 1974, and a supplemental report covering the period January 17 through 21, 1974. Copies of these reports have been placed in the files of the Committee.

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

> Since the Committee's last meeting the dollar has continued to strengthen against the major European currencies and the yen, with a particularly sharp rise yesterday following the weekend announcement of French recourse to a floating rate on the franc. As of this morning, sterling is trading about 17 per cent below its Smithsonian parity while the lira has suffered almost as much, with a 15 per cent discount against the Smithsonian parity. The floating French franc has now broken through the Smithsonian parity and is currently being quoted about 2 per cent below that level. The mark, Belgian franc, and Dutch guilder are still trading well above Smithsonian levels--but about 20 to 30 per cent below their peak levels of last July. The Japanese market, which was closed yesterday in the wake of the French withdrawal from the snake, remains closed today. I think there is some likelihood when the market is reopened that continued selling pressure may weaken the yen rate further from last Friday's level of 300 to the dollar. The Smithsonian level was 308 to the dollar.
>
> In general, last February's devaluation of the dollar and its subsequent further depreciation in the exchange markets have now been about wiped out. The

question now arises whether this reflects an appropriate adjustment to the energy crisis and whether rates will now settle down in orderly trading around current levels. Judging from what happened to the dollar last spring, I would have little hope that market forces can be relied upon to restore orderly markets and to maintain an appropriate exchange rate structure. Rather, I think we may be on the verge of relapsing into an even more dangerous situation than the one that developed during the fall of 1971. All currencies are now vulnerable to massive speculative pressure, either up or down, and in the absence of any official consensus on appropriate exchange rate relationships, few central banks now seem prepared to mount a determined defense of any given rate. So we have a situation facing us in which, for example, the French franc may suddenly come under strong selling pressure; the Bank of France will allow the franc to fall sharply; this in turn will generate market speculation that, say, the lira or sterling is overvalued relative to the franc; and the speculators will move around the circle, as they have been doing for some months. At some stage, just as occurred to the dollar last summer, individual foreign currencies will be driven so far below their natural levels as to bring about an abrupt reversal of the speculative tide now favoring the dollar. What I fear, in effect, is another roller-coaster pattern of exchange rate movements, of the kind we've seen during the course of the past year. And as rates move erratically in response to speculation, I think there will be a grave risk in the current every-man-for-himself atmosphere of further widespread official resort to exchange controls and possibly to trade controls as well.

In the fall of 1971, business confidence abroad was severely shaken by the threatening breakdown of world trade and finance as controls proliferated. That, of course, was the basic reason for the urgency at the time of the Smithsonian meeting for reaching agreement on an appropriate structure of exchange rates. This time, against the background of the energy crisis and all of our other problems, the problem could be very much more severe than it was in the fall of 1971.

As I see it, two things need urgently to be done if events are not to slip out of control. First, we

need some rough official judgments as to the appropriate exchange rate relationships in the light of the differential impact of the energy crisis. Secondly, the Federal Reserve and the other central banks have to be assured of adequate financial resources to fend off unwarranted speculative attacks on whatever exchange rates are thought by official consensus to be defensible and appropriate. For the Federal Reserve I see no immediate need for new authority to borrow foreign exchange from our swap partners, although such a need may develop later. In our own longer-run interests, however, we might soon find it desirable to reactivate our lending arrangements under the swap network and to stand prepared to increase individual lines if that should seem desirable in order to meet an unwarranted speculative onslaught on one currency or another.

More generally, what is developing is a growing over-all shortage of international liquidity. There has been concern for a long time about the problem of the large dollar overhang, but the energy crisis has decidedly changed that situation, at least in the minds of foreign central bankers. Gold has been immobilized. SDR's also have been immobilized, and whether or not they will ever become a major new source of international liquidity, it is clear that they will not do so in time to be of help in dealing with the present problem. Beyond the mounting shortage of international liquidity, there is a problem of acute maldistribution. There is a large volume of dollars in official hands around the world, but--except for the large German holdings, which that country now seems inclined to retain--they are moving, by and large, into the hands of the oil-producing countries. That process is going to leave a number of other countries acutely short of reserves, a fact which will be noted in the exchange markets. I think we can expect severe speculative attacks on currencies based mainly on the possibility that the countries involved will simply run out of money. It is conceivable that some procedure will be developed for recycling some of the funds accruing to the oil producing countries, perhaps through the International Monetary Fund, but I would be personally doubtful that that can be done in time. Therefore, I believe that, as on many occasions

> in the past, the main hope for preventing the situation from becoming increasingly disorderly lies in the central bank credit facilities, including the Federal Reserve swap network. If it proves necessary to supply a large amount of money to some individual foreign central bank, it would, of course, be desirable to get other central banks with adequate resources--such as the German Federal Bank--to join forces with us in some sort of package support.

By unanimous vote, the System open market transactions in foreign currencies during the period December 18, 1973, through January 21, 1974, were approved, ratified, and confirmed.

Chairman Burns said he thought there was a need for the Committee to reexamine the swap arrangements. He was not sure he agreed with Mr. Coombs that central bank credit facilities offered the main hope for dealing with the financial problems arising out of the oil crisis, but he did agree that the System could make a contribution to that end and that it should not hesitate to do so. As to how to proceed, he had a concrete suggestion to offer.

During his visit to Rome for the C-20 meeting, the Chairman continued, he had been approached by officials of the Bank of Italy about the possibility of an increase in the System's swap line with that Bank, which was now $2 billion. The matter was a rather urgent one and an early decision was desirable. His concrete suggestion was as follows. First, that the System's swap line

with the Bank of Italy be enlarged from $2 billion to $3 billion. Second, that the System acquiesce if the Bank of Italy should desire to make an immediate drawing on the swap line, but that it require that Bank to assume all of the market risk involved in the initial drawing. In other words, if the Bank of Italy were to draw $500 million, it would undertake to repay that dollar amount no matter what happened to the market exchange rate for the lira against the dollar. Third, that in accordance with past practice, the interest rate on any drawing should be equal to the U.S. Treasury bill rate. Finally, when the enlargement of the Italian swap line was announced, the Federal Reserve would indicate that it was willing to consider the enlargement of other swap lines, as needed. However, the System would take no further action at this time; the initiative with respect to any further enlargements would be left with the foreign central banks, as it had been in the Italian case.

Chairman Burns noted that from preliminary discussions with Treasury officials he had the impression that they would be favorably inclined toward a proposal along those lines. Further discussions with the Treasury would be held in a meeting scheduled for this afternoon. He thought it would be desirable for the Committee to act on his suggestion this morning, leaving the

question of final approval to the Subcommittee named in the Committee's rules of procedure after consultation with the Treasury. It would be understood that the Subcommittee would be authorized to make any minor changes in the proposal that might be needed. If major changes were required a telephone conference of the full Committee would be called to discuss them, assuming there was time to do so--and he expected that there would be.

The Chairman then invited comments on his suggestion, noting that it was, in effect, a modification of the broader proposal that Mr. Coombs had made.

Mr. Daane said he thought Mr. Coombs had properly flagged the need to arrive at some new official judgments about appropriate exchange rate relationships. As he had noted in last night's FOMC session, there was considerable sentiment at the recent Basle meeting for President Zjilstra's view that it was necessary to determine the appropriate exchange rates before intervening. The Canadian representative had made a particularly strong case for a reappraisal of exchange rates, along the lines of that carried out prior to the Smithsonian meeting.

Chairman Burns asked Mr. Coombs to describe the procedures he thought might be followed in obtaining such a reappraisal.

Mr. Coombs said he believed the needed judgments could be arrived at through a series of telephone conversations with the appropriate officials in the different countries. Each country had two main concerns: whether its own exchange rate was in line with the prevailing rates of other countries; and what changes were likely in other exchange rates. He suspected that most countries considered their current exchange rates not very far out of line with others, and that they were aware that further declines in their rates would expose them to the risk of importing inflation on a major scale.

Mr. Daane remarked that, while bilateral conversations of the kind envisaged by Mr. Coombs would be useful, it was unlikely that they would be sufficient to arrive at the needed judgments about the appropriate structure of rates. In his view, multilateral discussions such as those which preceded the Smithsonian meeting would be needed.

Chairman Burns concurred in Mr. Daane's view. At the same time, he thought it would be unwise to call an international meeting now to discuss appropriate exchange rates, since such a meeting would create market unsettlement. Perhaps the best means for beginning the needed process would be to hold a quiet discuscussion at the next Basle meeting. If President Zjilstra was

asked in advance to schedule such a discussion, each central banker at Basle would have had an opportunity to prepare by taking the question up with his Finance Ministry and perhaps others in his government. It also would be desirable to invite the Managing Director of the IMF to attend the meeting.

Mr. Daane expressed the view that such a procedure was worth trying.

Mr. Coombs observed that there would be great danger at the moment in a public and protracted bargaining session. The sooner that even a rough approximation to appropriate rate relationships could be arrived at, the better it would be.

Mr. Daane then asked whether Working Party 3 was not planning a discussion of appropriate rate relationships in its meeting scheduled for mid-February.

Mr. Bryant replied that the exercise planned by the WP-3 was more limited in scope; it would be concerned primarily with the constellation of current account positions among countries and with the question of how they might be financed. To be sure, one of the objectives of the exercise was to begin to form views about the pattern of exchange rates and the policies that would be appropriate. In general, however, he personally was rather pessimistic that it would prove possible to reach agreement soon on a set of exchange rates, either in WP-3

or in some other forum. The conditions that existed prior to the Smithsonian meeting did not exist today.

The Chairman observed that the range of uncertainty was much greater now than it had been at the time of the Smithsonian meeting. Therefore, he shared Mr. Bryant's skepticism about the outcome of the proposed discussions. At the same time, he shared Mr. Coombs' views on the desirability of reaching agreement on appropriate exchange rates. Accordingly, he believed that the attempt should be made.

Mr. Coldwell remarked that the Committee traditionally had considered its swap network as a short-run credit facility, designed to cope with flows that were expected to be reversed soon. Considering the magnitude of the flows that would be associated with oil payments, any borrowings undertaken to finance them might well remain outstanding beyond the 3-month term of a swap drawing, and beyond the 6-month term of a drawing that was renewed at its first maturity. He asked whether the proposal the Chairman had made contemplated a shift toward longer-run terms for swap drawings.

Chairman Burns observed that the question Mr. Coldwell had raised was an important one. He asked Mr. Coombs to comment.

Mr. Coombs remarked that in the past the System had repeatedly faced the problem of distinguishing between short- and longer-run flows. A movement of funds that appeared to be speculative in origin and that was financed by a swap drawing could prove to be based on a longer-run disequilibrium, so that difficulties were encountered in unwinding the drawing. The solution relied upon in such cases was a "takeout" arrangement; when a central bank found that it could not in due course pay off a short-term drawing it had made on the System, it was expected to liquidate its debt by borrowing at medium-term from the IMF or other sources. Since it was never possible to say with certainty whether some particular situation would be of short duration, it seemed reasonable to him to have facilities available for converting short-term credits to medium term.

The Chairman observed that in recent years the System itself had drifted into long-term borrowing under the swap lines.

Mr. Coombs remarked that in earlier years--from 1962 to 1971--the record of repayments of swap drawings had been quite good. Over that period roughly two-thirds of all swap drawings had been repaid within 3 to 6 months.

Mr. Daane commented that he personally had been surprised by Mr. Coombs' implication that the swap network could be used to

help meet the growing shortage of international liquidity. He agreed that the swap lines had an important role to play as a short-term credit facility. He thought, however, that it was necessary to look to SDR's or some other instrument to meet the urgent need for secular growth in world liquidity.

Mr. Brimmer said he believed it would be unwise for the Committee to lengthen the customary repayment periods for swap drawings or to depart in other ways from the traditional concept of the swap network as a short-term facility. With respect to the System's own drawings, the Treasury had agreed in 1968 to take over any debts that threatened to run on too long; indeed, he thought it was because the Treasury had done so on several occasions that the repayment record Mr. Coombs had cited was so good. Currently, however, there was one swap line--that with the National Bank of Belgium--which the System had had in continuous use since mid-1970. With respect to any drawings that might be made by other parties now, he hoped the Committee would proceed on the assumption that they would be of a short-term character.

Mr. Coldwell observed that, like Mr. Daane, he would distinguish between short-run adjustment credits and the provision of liquidity. If the System were to be supplying international liquidity through its swap network, it would not be reasonable to expect drawings to be repaid within 3 months.

Mr. Coombs observed that it might be helpful if he explained what he meant by the word "liquidity." He was thinking in terms of someone in the foreign department of a central bank whose task it was to intervene in the exchange market. To such a person, liquidity was whatever enabled him to intervene; it did not matter for that purpose whether the liquidity at hand would disappear in 3 or 6 months. The swap lines were one source of that kind of liquidity. There was no inconsistency between that function of the swap lines and the provision of some other form of liquidity over the longer run--say, by the progressive enlargement of the stock of SDR's. The two were complementary.

Mr. Coldwell asked whether it would be expected that any new drawing by a foreign central bank would be repaid within 3 months.

Mr. Coombs replied that he would prefer to say that there would be a hope of repayment in 3 months and an expectation that the borrower would make every effort to repay within a year.

Mr. Holland observed that the Committee's traditional posture had been that in the absence of unusual circumstances drawings on a swap line should be cleared up within a year of the date at which the line was first activated. It was true that the individual drawings were for 3-month periods, but they were subject

to renewal. He assumed that, in proposing an enlargement of the swap line, the Italians expected to be able to repay any drawings they might make within a year.

Mr. Daane remarked that the key question was whether the swap lines were to be viewed as a longer-term financing facility. Considering the whole energy payments problem, and the particular problems of developing countries, he would not want to suggest by any enlargement of the swap network that the System was treating that network as a source of long-term financing.

Mr. Coombs said he agreed completely. He added that the 3-month maturity dates on individual swap drawings served a useful purpose in keeping pressure on the borrower to find means of repayment. In connection with past drawings, the Bank of Italy had made repayments with funds borrowed in the Euro-dollar market. There was a wide range of alternative sources of funds for that purpose, including the IMF.

Chairman Burns observed that, as he had indicated earlier, the question Mr. Coldwell had raised was an important one. He personally would support the view that the Committee should hold to its present rules; that any drawings should be for 3-month terms, with an expectation--and a clear indication to the borrower--that if there were renewals they would almost certainly not extend

beyond one year. On that basis, the borrower would be expected to begin thinking rather early in the life of the drawing about alternative financing arrangements.

Mr. Hayes concurred in the Chairman's statement.

Mr. MacLaury said he would like to revert to the question discussed earlier about possible efforts to reach a consensus on the appropriate structure of exchange rates. He agreed that it would be useful to seek such a consensus, but he also shared the skepticism Mr. Bryant had expressed about the likelihood that that effort would be successful. Accordingly, he wondered whether it might not be better to place the main stress on reaching a consensus on a related subject--that of rules for intervention. He was not thinking primarily of the "indicator" approach the United States had been advocating in recent international discussions, but of much more informal understandings.

Mr. Daane commented that there had been a preliminary discussion of that subject in Rome. It was agreed that a technical group should explore the matter in depth before the next meeting of the C-20 Deputies, to be held at the end of March.

Mr. Daane then said he thought the course the Chairman had proposed with respect to the Italian swap line, including the contemplated discussions with the Treasury, was appropriate.

Mr. Coldwell remarked that if the swap lines were still to be considered short-run facilities, a question arose as to their appropriate size. In particular, he wondered whether an increase in the Italian line from $2 billion to $3 billion might suggest, say, that the German line should be raised from $2 billion to $4 billion.

Chairman Burns said he thought each proposed increase should be considered on its merits. Personally, as of this time, he would not favor an increase in the German line.

The Chairman then said he would like to advance another suggestion which was supplementary to the suggestion that a consensus be sought on appropriate exchange rate relationships and which might in practice prove to be a substitute for the latter. What he had in mind was to come forward rather soon with views on the appropriate relative levels of reserves of major countries--perhaps in terms of a range for each country--and to begin discussing those views with the countries involved. Not only did the question of appropriate relative reserve levels have a clear bearing on exchange rate relationships; some consensus on reserves would be needed if there was to be meaningful surveillance of the adjustment process by a reconstituted IMF.

Mr. Daane observed that there had been a start in that direction in connection with the U.S. proposal for reserve indicators, although no effort had been made to reach agreement on appropriate reserve levels.

Mr. Mitchell remarked that the terms on which it was proposed to increase the Italian swap line seemed in one respect to involve a departure from traditional practice. In the past, the swap lines had generally been viewed as mutual credit facilities, and the potential needs of both parties had been considered in deciding on their appropriate size. In today's discussion, however, it appeared to him that the question was being approached on the presumption that the Federal Reserve would be the lender. While he had no great objection to that approach, he would note that under current circumstances a borrowing country carrying the full risk of a decline in its exchange rate would be under heavy pressure to hold down the volume of borrowing; it would be subject to a degree of discipline that had not existed when the swap network was originally established.

Chairman Burns observed that for some time he had had in mind the need to consider the appropriate terms of swap drawings in a world of floating exchange rates; a different set of rules might well be needed from that used in the past. It might

be concluded, for example, that some sharing of the exchange risk between borrower and lender was appropriate. He was not prepared to offer a judgment on that point now. In any case, he would not want to act hurriedly to introduce new rules in connection with an initial drawing by the Bank of Italy, particularly since they would serve as a precedent for drawings by other countries. He understood that the Italians were willing to accept the full exchange risk, and other countries might take a similar position in connection with any drawings that they and the Federal Reserve might agree upon in the near future. For the longer run, however, the Committee would want to give careful thought to the terms on which drawings should be made.

The Chairman added that the question that had been put to him by Bank of Italy officials related specifically to a possible enlargement of the swap line, without mention of a desire on their part to make an immediate drawing. They might, however, want to draw on the line rather quickly. That was why he had made his proposal today.

Mr. Hayes said he agreed with the view that the swap lines should be considered mutual facilities, with their size based on the likely credit needs of both parties. At the same time, he thought it was appropriate for the Committee to take a flexible

approach to proposed increases when the need was pressing, as in the present case of the Italian line. An enlargement of that line now obviously would be intended primarily--indeed, almost entirely--for the purpose of facilitating borrowing by the Bank of Italy rather than by the System. The time might come, as it had in the past, when there would be uncertainties about the likely direction of exchange market pressures, and when there would be advantages, in terms of improving the atmosphere in the markets, of more general increases affecting a number of swap lines. That prospect, however, should not prevent the Committee from responding to a pressing problem that had arisen now.

Mr. Coombs observed that he agreed with much of what Messrs. Mitchell and Hayes had said concerning the reciprocal character of the swap lines. He might note that the normal understanding in the past had been that the borrower would carry the full exchange risk, apart from the exceptional circumstance of a revaluation by the lender. The arrangement for a 50-50 sharing of profits and losses on System drawings that had been worked out with certain central banks last July was a special *ad hoc* agreement; from the first, it had been intended to be temporary and subject to change on short notice. In fact, the time might already have arrived when that arrangement was a dead

letter and it would be possible to activate the swap lines only if the borrower agreed to carry the full exchange risk. Whatever future agreements might be reached on that score, however, it seemed clear that the Italians had been prepared to borrow heavily in the Euro-dollar market, accepting the full exchange risk, and that the Bank of Italy would see no obstacles to borrowing from the Federal Reserve on the same basis.

Mr. Mitchell observed that in a world of fixed exchange rates a borrower carrying the full exchange risk would bear the cost of a currency revaluation by the lender.

Mr. Coombs replied that so long as exchange rates had been fixed it had been the general view that a creditor country revaluing its currency would be inflicting an unreasonable burden on the debtor country if it did not protect the latter against the consequent losses. That was the basis for the so-called revaluation clauses in the swap contracts. That situation could not arise in a world of floating exchange rates; when exchange rates moved relative to one another on a floating basis, it was not possible to identify any particular part of the change as a "revaluation." The general presumption, he believed, would be that the debtor country, rather than the creditor, was responsible for any decline in the relative value of its currency and should bear the resulting cost.

Mr. Coldwell asked about the bases for determining the appropriate size of individual System swap lines. For example, was it possible that the large increase in the Italian swap line would raise the question of how large other lines should be?

Mr. Coombs replied that in his judgment the key consideration was the potential swing in a country's payments--that is, the volume of reserves it was likely to need. As the volume of world trade and payments grew, the need for financing would be expected to grow. The basis for the whole SDR exercise lay in the need to expand international liquidity in some relationship to the growth of world trade and payments. For the same reason, it was natural to expect the System's swap network to expand over the years. Indeed, the growth in the network over the past decade had been in response to increased swings in the flows of payments.

Chairman Burns remarked that it was important to keep in mind the desirability of having other central banks join with the System in providing needed credit facilities. While he thought it would be reasonable for the Federal Reserve to act alone in a $1 billion enlargement of its swap line with the Bank of Italy, if that amount proved insufficient an effort should be made to get the German Federal Bank, for example, to participate in extending

credit to the Italians. At no point should the Federal Reserve permit itself to become the sole source of central bank financing.

Mr. Coldwell remarked that he had such considerations in mind in raising a question about the potential size of the System's swap lines. If the Federal Reserve were to enlarge the Italian line by $1 billion now and perhaps make corresponding increases in other lines over the coming months, the point might soon be reached at which consultations with the Congress might be needed regarding the System's authority to extend credit on the proposed scale.

Mr. Daane noted that the Treasury would be consulted regarding the proposed increase in the Italian swap line, and presumably in connection with any further enlargements of the network.

Chairman Burns commented that Mr. Coldwell's point was well taken; the Congress might well become concerned about the magnitude of System lending.

Mr. Mitchell observed that, as had been noted earlier, the swap lines were symmetrical arrangements; they provided facilities for financing swings in the payments flows of the United States as well as in those of its swap partners.

Mr. MacLaury referred to the Chairman's suggestion that the public announcement of the enlargement of the Italian swap line should include a statement that the Federal Reserve was willing to consider enlargements in swap lines with other countries, as needed. He asked whether that was an integral part of the proposal.

Chairman Burns replied that in his judgment such a statement would serve a useful purpose.

Mr. Daane observed that it would be desirable to word that statement in a way that did not imply an intention to enter into arrangements with countries not now in the swap network, and Chairman Burns agreed.

Mr. Brimmer said he was prepared to support the Chairman's proposal.

> By unanimous vote, the Committee authorized an increase from $2 billion to $3 billion in the System's swap line with the Bank of Italy, and the corresponding amendment to paragraph 2 of the authorization for foreign currency operations, to become effective upon approval by the Subcommittee named in Section 272.4(c) of the Committee's rules of procedure after consultation with responsible officials of the U.S. Treasury.

Secretary's Note: Pursuant to the foregoing action, on January 29, 1974, the Subcommittee approved the indicated increase in the System's swap line with

the Bank of Italy and the corresponding amendment to the authorization for foreign currency operations, effective February 1, 1974.

Mr. Coombs then noted that a number of System swap drawings would mature for the tenth time in the period from February 1 through February 15. They included six drawings on the National Bank of Belgium, totaling $230 million; two drawings on the Swiss National Bank, totaling $438.5 million; and one Swiss franc drawing on the BIS, of $600 million. Specific authorization by the Committee was required for the renewal of those drawings, since the swap lines in question had been in continuous use for more than one year.

Mr. Coombs observed that some progress had been made recently in reducing the outstanding Swiss franc debt; some $126.5 million had been paid off since the last Committee meeting, and further repayments might be possible before the end of the month. No repayments had been made on the Belgian franc debt because of the Treasury's request--originally made nearly 3 months ago--that the System not buy Belgian francs in the market for that purpose pending the outcome of Treasury negotiations with the Belgian authorities. He might note that during the period in question the interest charges on the System's debt to the Belgians had cumulated to about $5 million, more than half of the amount

the Treasury hoped to save through negotiation. In his judgment, it might be better for the System to acquire the francs needed to liquidate the debt at present exchange rates--which were attractive--rather than to delay any longer in the hope of a successful outcome to the Treasury's negotiations.

Mr. Daane said he might mention a development of which Mr. Coombs, who had been on vacation, might be unaware. Under Secretary Volcker had discussed the matter in Rome with the Belgian Finance Minister, and the latter had indicated that the Treasury's proposal would be given favorable consideration.

Chairman Burns remarked that a response from the Belgians was expected shortly. It might be noted, however, that the Finance Minister with whom Mr. Volcker had talked was no longer in office.

Mr. Holland remarked that he hoped the System would make stronger representations than previously to the Treasury of its desire to clear up the outstanding swap debt to the Belgians.

> By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, the Swiss National Bank, and the Bank for International Settlements, maturing in the period February 1 to February 15, 1974, was authorized.

Chairman Burns then called for the staff report on the domestic economic and financial situation, supplementing the

written reports that had been distributed prior to the meeting. Copies of the written reports have been placed in the files of the Committee.

Mr. Partee made the following statement:

The incoming evidence recently has pointed increasingly to a weakening of demands in the U.S. economy. As a result, the industrial production index fell and the unemployment rate rose last month, and further deterioration is in immediate prospect. Manufacturers' new orders for durable goods also declined dramatically in December--by 6 per cent--with sizable reductions extending well beyond the automobile industry.

New car sales have been notably poor, as was expected with the onset of the oil crisis. Unit sales of domestic makes fell off to a 7.9 million annual rate in December, and further--to a 7-1/2 million rate--in early January. Large cars in particular are not selling, of course, and industry inventories--mainly of these large models--had built up to a 69-day supply at the end of the year. Accordingly, output has been cut sharply, by 15 per cent in December and another 15 per cent in January. Current information on other consumer durables dependent on the use of fuel is not available. But anyone who saw the news pictures last week of Winnebago motor homes crowded onto the manufacturer's lot can hardly doubt that these expensive recreational vehicles, at least, have not been doing at all well.

Residential construction activity has also been notably weak--in this case, I fear, weaker than we had anticipated. It may well be that lack of any year-end flurry in Federally-assisted starts helped push housing starts down by 20 per cent from November to December. But the volume of building permits issued was quite low throughout the fourth quarter, and seems consistent with a level of housing starts not in excess of about 1-1/2

million units. Merchant builder sales continued poor through November--about one-third below the year-earlier level. Here, also, newspaper reports are exceedingly gloomy; the more remote subdivisions are said to be having great difficulty even in attracting lookers, much less buyers.

Consumer spending generally, though not nearly so weak as for autos and housing, has been on the lack-luster side for a good many months. Christmas sales of general merchandise stores did show a good gain, although sales at furniture and appliance stores and apparel shops were off. More importantly, however, there appears to have been no growth in real volume, either for December or over the third and fourth quarters as a whole, in the broad category of retail trade exclusive of autos. Real earnings per worker have continued to decline in recent months, and recent surveys of consumer attitudes remain very pessimistic.

Under the circumstances, it is not surprising that a sizable increase in inventory investment is shown in the fourth-quarter GNP estimates, even though real output apparently increased very little. We had been anticipating a gradual pickup in inventory accumulation, as businessmen became more successful in stocking up on the long list of materials and components in short supply. But the acceleration in inventory building to date does not appear to have been of this type. Almost all of the pickup has taken place in wholesale and retail trade rather than manufacturing. And it has not been confined by any means to autos. There is a presumption that a considerable part of the accumulation has been unintended--reflecting weakness in final sales--and therefore it must be regarded as a minus in the near-term business outlook.

The staff projection continues to call for some decline in real output over the first half of 1974. This is so even though the oil shortage now appears less severe than was expected earlier, and even though we anticipate continued strength in business capital investment along the lines of the 12 per cent increase indicated by the year-end Commerce survey. A rapid, continuing increase in the price level will be impinging on real personal income; consumer spending is likely

to remain depressed in the whole auto and travel category; and some adjustments in output--not only in autos but in other consumer goods lines--appear needed in order to balance inventories that now seem a little high relative to near-term sales prospects.

The configuration of the economy, however, still does not seem consistent with that of a classic business recession. Business inventories as a whole appear quite conservative relative to business sales. Capital spending incentives still appear to be quite strong, reflecting not only severe capacity limitations in many important industries but also the need to invest for energy-saving purposes. Effective consumer demand is being limited in part by the inability of manufacturers to adjust quickly to a new pattern of consumer desires. Therefore, we continue to project some recovery in real activity in the second half of the year, as the capacity to produce small cars expands and as residential building begins to recover once again.

The obvious pitfall in this is that sufficient income may be destroyed by near-term reductions in output and employment to undermine the beginnings of economic recovery that we see in prospect. Unemployment has risen rapidly in recent weeks, judging by the data on employment insurance claims, and growth in aggregate income has undoubtedly slowed. But purchasing power will be buoyed in coming months by the large tax refunds to be paid out again this spring and by the increases in social security benefits scheduled for April and July. Incomes will be partially maintained also by rising governmental transfer payments to the unemployed and, in the auto industry, by supplemental unemployment benefits.

The recovery we have projected for the second half depends also on a slowing in the rise in consumer prices, as petroleum prices stabilize at a new higher level and food supplies finally expand enough to moderate or halt the sharp, continuing rise in food costs. In the expectation that these adjustments will largely be completed by midyear, we have projected an appreciable slowing in the inflation rate in the second half of 1974. Whether such a slowing will in fact occur

> depends importantly on the course of wage-rate increases and on productivity. The recent news on that score has not been favorable. Unit labor costs in the non-farm sector of the economy are estimated to have risen in the fourth quarter of 1973 at around a 10 per cent annual rate. Continuing and self-generating inflation, therefore, remains an extraordinarily serious threat. Weakness in economic activity and possible recession on the one hand, and continued rapid inflation on the other, seem to me to pose severe constraints on the range of policy options available to the Committee.

Mr. Morris noted that projections for the first half of 1974 made at the Federal Reserve Bank of Boston agreed with the Board staff's projections with respect to the magnitude of the decline in real GNP. However, that agreement resulted from offsetting differences in the behavior of components. For one thing, the Bank staff expected substantially more weakness in residential construction in the first quarter than was suggested by the green book[1/] forecast that housing starts would be at a 1.5 million rate.

Mr. Partee said he was inclined to agree on that point. The Board staff's projection for the first quarter probably would have been lower than shown in the green book if the information that housing starts had dropped to a rate of 1.36 million units in December had been available at the time the projection was made.

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

Mr. Morris went on to say that the other main difference was in the figures on inventory investment, for which the Bank's projections were higher than those in the green book. There appeared to be a strong propensity to hoard on the part of purchasing agents, and that was likely to result in increased inventory accumulation in the first quarter. For example, a major producer of carbon black, which is primarily used in the manufacture of tires, reported extremely strong demand for that product--even though tire production was expected to decline because of cutbacks in automobile output and in the number of miles driven as a result of the gasoline shortage. The only possible explanation was that tire manufacturers were hoarding carbon black. If hoarding was proceeding on as large a scale as he suspected, there was bound to be a reversal later on. Inventory behavior was now an element of strength, offsetting the decline in residential construction, but it could result in greater weakness than expected later in the year.

In response to a question by the Chairman, a number of Reserve Bank Presidents indicated that businessmen in their Districts were attempting to build up inventories of both materials and goods in process.

Mr. Sheehan observed that businessmen were probably also placing multiple orders to ensure delivery, with the intention of cancelling the excess orders later.

Mr. Coldwell remarked that in a study of about 200 firms in the Eleventh District his staff had found widespread indications of raw materials stockpiling over recent months. Some of the firms now had a full year's supply of raw materials on hand, whereas they normally held about a 2-month supply.

Chairman Burns asked if such inventory accumulation was motivated primarily by concern about expected price increases or by a fear of shortages.

Mr. Coldwell replied that many of the firms in question had initially begun building up inventories in the summer of 1973 in anticipation of price increases. They intensified their efforts later, when the first suggestions of potential shortages began to appear.

The Chairman asked whether the available statistics on inventories of raw materials tended to confirm the reports of business hoarding.

Mr. Partee replied that the available data on manufacturing inventories of materials and supplies showed only a relatively moderate pickup in purchased materials inventory investment during

1973. In book value terms, the rate had increased from $4.8 billion in the first quarter to $5.5 billion in the second, $7.0 billion in the third, and about $6.5 billion in the October-November period, with much of that advance undoubtedly accounted for by rising prices.

Mr. Francis remarked that large-scale hoarding by some firms might well have been largely offset by the inability of other firms to obtain needed stocks.

Mr. Partee said he also expected businessmen to attempt to increase stocks of scarce raw materials. He might note that the $13.0 billion increase in business inventories shown in the staff's projection for the first quarter reflected both an expected increase in manufacturers' inventory accumulation, based on anticipatory buying of the kind suggested by Mr. Morris, and an expected decline in retail auto stocks. The staff believed that by the end of the first quarter automobile manufacturers would have cut production of large cars substantially and that retailers would have sold some of their present inventories of such cars.

Mr. Bucher asked which consumer surveys Mr. Partee had had in mind when he said that such surveys indicated continuing pessimistic attitudes.

In reply, Mr. Partee noted that the latest University of Michigan survey suggested consumer pessimism. However, he had been thinking particularly of the weekly Sindlinger survey, according to which confidence had recently dropped to its lowest point in years. Although individual observations in that survey were not necessarily significant, he would give some weight to a decline in confidence levels as pronounced and sustained as successive canvasses had recently shown.

Mr. Bucher then asked whether the staff had estimated the volume of income tax refunds in 1974.

Mr. Partee responded that the staff anticipated total tax refunds of about $22 billion in 1974, as compared with $20 billion in 1973. The expected increase of $2 billion was much smaller than the increase that occurred from 1972 to 1973.

Mr. Hayes noted that the Board staff projections assumed the oil embargo would continue through 1974. He asked how the projected change in GNP from the fourth quarter of 1973 to the fourth quarter of 1974 would be affected if it were assumed instead that the embargo would be terminated by the end of the first quarter.

Mr. Partee replied that the staff had decided to delay making such alternative projections until there was better

information about the likely duration of the embargo and the terms on which it might be ended. The staff had reexamined the GNP projections made in December in light of the apparent improvement in availability of gasoline. However, it had made no significant change on that account because the impact of rapidly rising fuel prices on consumer purchasing power appeared to offset, in good part, the improvement in supply prospects. Similarly, he thought that what longer-run effects might stem from termination of the embargo would be influenced by the price assumption and by the rates of foreign oil output that would actually develop.

Mr. Hayes agreed that there was necessarily a great deal of uncertainty in any such projections. For what it was worth, however, he might note that the staff of the New York Reserve Bank had estimated that the growth of real GNP between the fourth quarters of 1973 and 1974 would be about 0.5 per cent if the embargo persisted throughout the year and about 1.8 per cent if the embargo were lifted at the end of March.

Mr. Hayes then said he had received the impression in conversations with businessmen that the termination of price controls was likely to be followed by a strong and widespread wave of price increases. He wondered what the staff's judgment was on the matter.

Mr. Partee replied that there was a strong possibility that there would be upward price adjustments in some industries, such as steel, copper, and paper products. However, the controls program itself had generated upward price pressures in some industries by inducing shortages and distortions in production, and those pressures would be eased by an ending of the program. He might note also that the Board's quarterly econometric model cast doubt on the extent of the over-all price adjustment that might come from controls termination. That model had consistently predicted higher-than-actual price increases beginning in the fall of 1971, when the wage-price controls were imposed, into early 1973. More recently, however, the gap between the trend of projected and actual prices had narrowed greatly, reflecting exemptions and perhaps also slippages in the program, and it was now quite small. Those results suggested that by early 1974 the price level was not much below what it would have been if there had been no price controls. On the whole, however, he found the question of probable price behavior after the lifting of controls to be an exceedingly difficult one.

Mr. Hayes then asked why the staff had assumed a growth rate of 6 per cent for M_1 in its latest GNP projections, given the fact that the Committee had adopted a 5-1/4 per cent target for longer-run growth in M_1 at recent meetings.

In response, Mr. Partee observed that the assumption of a 6 per cent M_1 growth rate had seemed to the staff a necessary condition for the economic recovery shown in the judgmental projection. The projected recovery in residential construction was a key factor in the recovery of over-all economic activity, and strength in housing depended on the availability of mortgage money. If market interest rates were to rise much above current levels, their spread over the rates paid by savings institutions would widen, and it seemed unlikely that there would be the inflows of time and savings deposits at commercial banks and thrift institutions necessary to support the mortgage market. The observed relationships between M_1, GNP, and interest rates implied that in order to prevent interest rates from rising appreciably--given the projected growth in nominal GNP--M_1 would have to increase at an annual rate of about 6 per cent. If an M_1 growth rate of 5-1/4 per cent were assumed, the projected levels of GNP would be reduced somewhat.

Mr. Coldwell asked if the staff had observed any change in the length of the lags among housing permits, starts, and completions. Some contractors in the Eleventh District had reported that shortages of materials and labor were causing delays in completions, and he wondered if the staff had any statistical evidence that that was occurring on a national scale.

Mr. Partee replied that there did not appear to have been a significant change in the relationship between permits and starts, but the statistical series on completions did suggest a considerable lengthening of the lag between starts and completions. The completions series had been available only since 1970, and the lack of historical perspective--as well as the volatility of starts--made it difficult to draw firm conclusions on the point. One factor which might be significant was the increase in recent years in the proportion of multi-family buildings, which took longer to complete than single-family dwellings. A sizable increase in multi-family completions was expected in the spring.

Mr. Kimbrel asked about the assumptions the staff had made regarding the size of wage adjustments in the labor contracts to be negotiated in 1974.

In response, Mr. Partee noted that the major wage contracts that would expire this year--which covered a very large number of workers--were mostly those that were last negotiated in 1971, immediately prior to imposition of wage-price controls; there was a 3-year cycle of major contract expirations. Because of the substantial inflation that had occurred over the past year and a half and the recent decline in real spendable earnings of production workers, he believed that unions would press for large wage increases

or for increases plus full cost-of-living escalators in the new contracts. Rising unemployment might tend to moderate the increase in the total wage bill, but that influence was likely to be more important in non-union settlements. The staff anticipated that wage rates would be increasing at an annual rate of about 8 per cent in the second half of 1974, and he believed that that could well prove to be a conservative estimate.

Mr. MacLaury noted that the staff was projecting an increase of 8.7 per cent in business fixed investment from 1973 to 1974. That figure seemed to him to be low, given the expected strength in business spending on plant and equipment.

Mr. Partee replied that the 8.7 per cent rise in the GNP category labelled "business fixed investment" was consistent with the anticipated 12 per cent increase in plant and equipment expenditures. The former category included several types of equipment excluded from the latter--such as trucks, automobiles used for commercial purposes, and farm machinery--and those were expected to show little or no growth in 1974.

Mr. MacLaury then observed that econometric simulations run by the staff at the Federal Reserve Bank of Minneapolis had produced projections of Treasury bill rates higher than the 7-1/2 per cent rate shown in the Board projections, even with the

assumption of a 6 per cent growth rate in M_1. He wondered if there had been some basic change in the econometric model used by the Board.

Mr. Partee replied that there had been no change in the econometric model. It was the judgmental projection that yielded a 7-1/2 per cent bill rate on the basis of a 6 per cent growth rate in M_1; for any given M_1 growth rate, the econometric model would produce both higher bill rates and a lower GNP. While he was not sure that he would still expect bill rates to remain as low as 7-1/2 per cent, he felt that the econometric model tended to overstate increases in interest rates because it did not allow for possible exogenous increases in the velocity of money.

Mr. MacLaury said his final question concerned the impact of two changes that had been made in the assumptions underlying the GNP projections since the December meeting: the increase in the assumed M_1 growth rate from 5-1/4 to 6 per cent, and the reduction of the assumed petroleum shortfall from 3-1/2 million to 2-1/2 million barrels per day. Since both of those changes appeared to be significant, he wondered why there had been relatively little change in projected GNP growth rate.

Mr. Partee replied that the staff also had found that result surprising, and consequently had examined it rather

carefully. The upward adjustment in the assumed M_1 growth rate did not yield a larger rise in real GNP because, as he had mentioned earlier, a more rapid rise in the money supply was now thought to be necessary to keep interest rates at levels consistent with the assumed rate of residential construction activity. The more rapid growth of the money stock simply made up for the more rapid increase now projected in the price deflator and thus did not help to raise real GNP. The improvement in the oil supply situation relative to that envisioned in earlier forecasts did result in higher estimates of spending on consumer durables, especially cars, but that was offset in real terms by increased weakness in other consumer expenditures resulting from the impact of higher prices on real takings.

Mr. Coldwell noted that the projected quarterly pattern of change in real GNP in the first two quarters of 1974 was different from that presented in the previous green book. Although both sets of projections showed declines in both quarters, in the current projection the decline was larger in the first quarter, whereas in the previous projection it was larger in the second quarter. He asked about the factors accounting for that change.

Mr. Partee replied that the difference--which was not very large in quantitative terms--was attributable mainly to two

factors. First, it was now anticipated that net exports would be strongly negative in the first quarter because of the sharp rise in foreign oil prices. Secondly, the staff now believed that the cutback in automobile production would be larger and more rapid than previously expected.

Mr. Francis observed that reports from contractors in the Eighth District tended to confirm Mr. Coldwell's observation that supply shortages were an important factor in the slowing of construction activity. Also, a large utility in his District reported that voluntary reductions in electricity consumption had been very effective. If that was the case nationally, it was possible that the recent decline in the industrial production index, which was based to an important extent on electric power consumption statistics, might be overstating the actual degree of weakness in industrial activity. Finally, he might note that reductions in output in some industries might release scarce resources, and thus be offset by expansion in other industries which had been hampered by materials shortages. For example, he had been told last week by members of the Tubular Exchanger Manufacturers' Association that makers of heat exchangers could use any steel supplies not needed by the automobile manufacturers.

Mr. Partee referred to Mr. Francis' comment on the production index and noted that the staff was calculating parallel output

series based on manhours data as a check on the 50-odd categories in the published index that were based on figures on electric power consumption. There appeared to be little difference between the two measures of output for those categories, at least through November--the latest month for which power consumption data were available. The decrease in total consumption of electricity had occurred mainly in the commercial and residential sectors rather than in the industrial area. The staff was continuing to monitor the situation closely, and if a significant differential developed between the series based on manhours and those based on power consumption, use of the latter would be discontinued.

As for the question of substitute demands, Mr. Partee agreed that the steel industry had been able to maintain a high operating rate despite the decline in orders from the automobile industry because of heavy demands from other industries. Nevertheless, the weakness in the automobile industry was having a significant impact on the economy, in terms of lost value added and reduced employment. Moreover, although other industries seemed to be taking up the slack in demand for materials generated by declining orders from the auto manufacturers at this time, it was possible that those demands would drop sharply later on, when the other industries had built their stockpiles up to desired levels and no longer felt threatened by shortages.

It was difficult to interpret statistics on orders at this time, Mr. Partee continued. On the one hand, as Mr. Sheehan had remarked earlier, there was some multiple ordering, and that tended to result in overstatement of orders. On the other hand, there also were firms which were refusing to take new orders.

Mr. Winn observed that there was need for more study of potential changes in the composition of the demand for housing. He noted that 10 or 15 of the largest builders of multi-family residences had either failed or withdrawn from the industry since 1972, while at the same time the demand for housing was growing and rents were rising sharply. If rents were to continue to accelerate, that might result in increased demand for single-family homes.

Mr. Winn also expressed concern about the impact of lay-offs in the automobile industry. Supplemental unemployment benefits--which would maintain workers' income at as much as 95 per cent of regular wages--were available to workers with one year's seniority, but he understood that most of the workers laid off thus far did not have that much seniority. As for projections of plant and equipment expenditures, he believed that such projections might prove to be somewhat low because a number of companies--in such industries as steel and paper

products--were planning expansion programs but had not been able to firm up their plans because of potential raw materials shortages.

Lastly, Mr. Winn observed that he was concerned about the pace of inflation and its implications for consumer confidence and spending patterns.

Mr. Balles asked if the estimate for Federal expenditures in fiscal 1975 given in the green book included allowance for any substantial increase in Federal spending for the relief of unemployment in distressed areas. He wondered whether the actual spending might not prove to be much larger than the $303 billion shown.

Mr. Partee said it was his understanding that the budget contained very little provision for new programs or special unemployment relief in distressed areas. A rise in unemployment would, of course, result in an automatic rise in unemployment compensation payments. Furthermore, he believed the budget provided for maintenance of the temporary public employment program that otherwise would have been phased out, but that probably represented an expenditure of only about $500 million. It was very likely that new Government initiatives would be introduced if serious unemployment developed in certain areas. Therefore, the estimate for Federal spending in fiscal 1975 might well prove to be too low.

Mr. McWhirter, Associate Director of the Board's Division of Federal Reserve Bank Operations, entered the meeting.

Chairman Burns suggested that before turning to a discussion of open market operations, the Committee discuss the report of examination of the System Open Market Account submitted by Mr. McWhirter on August 28, 1973, and the related memorandum from Mr. Holmes and letter from Mr. McWhirter dated January 3 and January 14, 1974, respectively.[1/] He asked Messrs. McWhirter and Holmes to comment.

Mr. McWhirter observed that a number of errors had been found in the records of the System Open Market Account at the time of the 1973 examination of that Account by his Division. The errors were of various sizes, and since some were in debits and some in credits, they were partly offsetting. All of the errors were reconciled prior to the conclusion of the examination, but not all had been corrected by that time.

Mr. McWhirter remarked that errors were highly unusual in the records of the Account. In the judgment of the examiners, which was shared by management, those that had been found were primarily attributable to a very large increase in the volume of

1/ Copies of the documents referred to have been placed in the Committee's files.

work at the Trading Desk with no increase in personnel, to problems with more or less obsolete computers, and to difficulties in getting work to and from the Computer Services Department at the Bank. Mr. Holmes, in his memorandum to the Committee of January 3, 1974, had described the steps that had been and were being taken to eliminate the unsatisfactory conditions noted in the examination report. In addition, he (Mr. McWhirter) had received a letter dated January 8, 1974, from the General Auditor of the New York Bank which indicated that none of the latter's audits since the examination by the Board's auditors had disclosed out-of-balance conditions. On the basis of the information in those documents, he (Mr. McWhirter) was prepared to say that, pending the next examination of the System Open Market Account by his Division, he was satisfied with the corrective measures that had been taken.

Mr. Holmes said he thought his memorandum was self-explanatory, and he would make only a few points. It had been a mistake to try to handle an increased volume of work at the Trading Desk without adding to the staff, and that had now been corrected. To illustrate the kinds of computer problems that were being encountered, he might note that the procedures which for 10 years had produced correct computations of accrued interest suddenly began yielding erroneous results. Additional progress in resolving

computer problems had been made since his memorandum to the Committee of early January. Two new machines that had been on order were delivered ahead of schedule. The old program had now been completely phased out and the new program seemed to be working well--except for a minor problem, that would be corrected shortly, connected with one type of Federal agency issue. Overtime work involved in the Account allocation had been eliminated by converting to manual procedures--a development which had substantially improved staff morale. The auditor's computer was now working quite well, and the Bank's continuous audit of the Account was proceeding without problems. On the whole, he believed the situation was now in good shape.

In the course of the ensuing discussion, Mr. Holland said he personally was prepared to accept the audit report together with the supplementary letter from Mr. McWhirter. He noted, however, that some of the needed improvements were still in process, and he thought the Committee would not want to wait until the next annual audit of the New York Bank for confirmation that the progress expected was in fact being made. Accordingly, he suggested that Mr. McWhirter be asked to submit a report to the Committee on that matter in, say, 3 months. As a basis for such a report Mr. McWhirter could rely on information

obtained from the New York Bank auditor, if in his judgment that was satisfactory.

There was general agreement that Mr. McWhirter should submit a report of the type described by Mr. Holland within 3 to 4 months.

Mr. Brimmer said he would prefer that Mr. McWhirter not rely on the New York Bank auditors for purposes of the report--although he might, of course, make use of their resources. Just as he (Mr. Brimmer) believed that the Division of Federal Reserve Bank Operations should constitute the eyes and ears of the Board in connection with Reserve Bank audits generally, so he thought that Division should constitute the eyes and ears of the Committee for the present purpose.

Chairman Burns said that that comment struck him as a wise one. He suggested that the matter be left to the judgment of Mr. McWhirter, who would bear Mr. Brimmer's comment in mind.

> The reports of audit of the System Open Market Account and of foreign currency transactions, made by the Board's Division of Federal Reserve Bank Operations as at the close of business July 27, 1973, together with the supplementary letter from Mr. McWhirter dated January 14, 1974, were accepted.

Mr. McWhirter left the meeting at this point.

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 December 18, 1973, through January 16, 1974, and a supplemental report covering the period January 17 through 21, 1974. Copies of both reports have been placed in the files of the Committee.

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

> Shortly after the last Committee meeting open market operations were directed towards achieving some easing of bank reserve and money market conditions, as called for in the directive. The basic approach was to move in stages--seeking first to achieve reserve conditions that would result in a Federal funds rate of about 9-3/4 per cent compared to the 10-1/8 per cent rate that had prevailed just prior to the last meeting. Despite the turbulence of the holiday season--with large seasonal needs for bank reserves and highly uncertain reserve projections--this objective was achieved, although it involved outright purchases of over $500 million of Treasury bills and over $3 billion of repurchase agreements in the December 26 statement week. While we had anticipated that this modest easing would be only a first stage, unexpected strength in the aggregates caused us to halt further moves towards an easing of bank reserve and money market conditions. By last Friday, however, estimates of growth in the aggregates in December and January had been revised downward, with M_1 well within the range of tolerance adopted by the Committee. Given the Committee's response to Chairman Burns' telegram of January 11, and the imminence of this meeting, we decided to continue an even-handed approach to reserve and money market conditions until the Committee reached a new policy decision today.

A mood of caution developed in the securities markets over the period as expectations of a progressive easing of money market conditions were disappointed. The persistence of inflation, the apparent strength in the published money supply series, international uncertainties, foreign selling of Treasury securities, and a heavy calendar in the corporate and municipal markets combined to create a cautious market atmosphere at the end of the period. Earlier in the period, dealers were able to market a large volume of corporate and municipal securities with considerable success, albeit at somewhat higher interest rates. In yesterday's regular Treasury bill auction, average rates of 8.00 and 7.82 per cent were set on 3- and 6-month bills, up 60 to 65 basis points from the averages in the auction just preceding the last Committee meeting.

Looking ahead, on January 30 the Treasury will announce the terms of its February refunding of $5.4 billion of maturing securities, of which $4.5 billion are held by the public. I would plan to roll over the System holdings of $535 million of the maturing issues into whatever issue or issues the Treasury offers.

I would also like to note the heavy volume of foreign central bank activity in the Government securities market. Over the period since the last meeting, we purchased over $1.5 billion of Treasury bills and $250 million of Treasury coupon and agency securities directly from foreign accounts, and we sold them $335 million of Treasury bills. In contrast, outright transactions by the System in the market added up to less than $400 million, although we made $7.1 billion of repurchase agreements and $4.6 billion of matched sale-purchase transactions, reflecting the huge swing in reserve needs over the period. During much of the period heavy net selling of Government securities by foreign accounts fitted in well with a need for the System to supply reserves. In the period ahead, on the other hand, we could have substantial foreign selling at a time when it appears unlikely that the System will need to supply reserves. If foreign sales do in fact turn out to be heavy, we may have to exercise some imagination and flexibility to avoid an undue impact on the market, while at the same time adhering to our reserve

objectives. In the past four Treasury bill auctions, we have bid to run off part of our maturing holdings, in part to make room for purchases from foreign accounts if the situation demanded. We will probably want to continue on this course. Finally, if foreign central banks do draw on System swaps, we will have a new reserve-supplying factor to contend with.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period December 18, 1973 through January 21, 1974, were approved, ratified, and confirmed.

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

The sets of specifications outlined in the blue book,[1] on the face of it, pose a dilemma for the Committee. If the Committee wishes to continue with a rate of expansion in the monetary aggregates consistent with M_1 growth at a 5-1/4 per cent annual rate between now and midyear, this may well involve a tightening of money market conditions. If the Committee wishes to maintain prevailing money market conditions, this appears to involve a move toward accepting a higher growth rate for M_1--one around 6 per cent. This is about the same growth as prevailed during 1973 on the basis of new, revised M_1 figures. An easing of money market conditions would seem likely to generate a still higher growth rate for M_1.

The greater rate of inflation now projected is the basic reason for the staff's conclusion that interest rates will remain at current levels or higher unless the Committee is willing to accept M_1 growth in at least the 6-1/2 to 7 per cent area. This greater rate of inflation is, of course, still associated

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

with weakness in real economic activity, as Mr. Partee has pointed out. The specifications presented to the Committee assume that the declines in interest rates ordinarily associated with such economic weakness will not show up--unless M_1 growth accelerates somewhat from last year's pace--because of efforts by the public to maintain the real value of their cash balances.

In setting its near-term policy course the Committee should, however, be well aware that the staff's specifications are subject to margins of error for the months ahead which are, I believe, even larger than usual. We simply cannot be very certain how the public will react to the set of economic circumstances that have come upon us.

For example, instead of attempting to maintain the real value of cash balances in a period of large price increases, the public may decide that the risk of further, if not accelerated, depreciation in the value of their cash is simply too great, and therefore they may attempt to move out of money to other assets. Or, we may find that in an effort to maintain living standards in a period of rising prices for fuel and other commodities, consumers will be willing to draw down cash and liquidity, at least temporarily. Some of this cash might be transferred abroad and there could be some transitional offsetting movements between domestic and foreign components of the money supply, at given interest rates, unless those abroad receiving the cash are well prepared with plans for investing the enlarged cash flow.

If the staff has, in fact, overestimated the demand for money in the period ahead, interest rates may well decline somewhat even with M_1 growing at about last year's pace or a little slower. In any event, with a very low M_1 growth seemingly in store for January, the January-February growth rate for M_1 is likely to be quite modest. The lowest growth rate over the 2-month period foreseen by the staff is 3 per cent, while the highest is 6 per cent.

In order to take account of the greater-than-usual uncertainty about the demand for money, the Committee may wish to consider utilizing that low and that high for its M_1 range of tolerance for the

> January-February period. The resulting 3 to 6 per cent range of tolerance would be the same as that adopted at the last meeting.
>
> There are perhaps even more pressing uncertainties about demands for goods and services. As the Committee knows, such uncertainties are, and have been, an argument for maintaining growth in the aggregates while permitting a fairly wide variation in interest rates. Though the forthcoming Treasury financing may be something of a damper on the timing and extent to which the Committee may wish to seek interest rate changes, the Committee may also wish to consider giving recognition to the high degree of uncertainty as to the strength of demands for goods and services by adopting a Federal funds rate range that is at least no narrower than in the recent past. The range adopted at the last meeting was 1-1/4 percentage points.

In response to a question by Mr. Daane, Mr. Axilrod observed that the maintenance of prevailing money market conditions was associated with alternative B of the three alternatives presented for Committee consideration.[1/] Although prevailing money market conditions appeared to involve an annual rate of growth of around 6 per cent in M_1 over the next 6 months--a somewhat higher rate than had occurred in recent months--the growth rate was expected to be only about 5-1/4 per cent in the first quarter of the year and to be within a range of 3-1/2 to 5-1/2 per cent in the January-February period, reflecting a very low rate in January. The staff expected the rate to be higher

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

throughout the second quarter, averaging around 7 per cent, in association with payments of large Federal income tax refunds and initial payments of higher social security benefits.

Mr. Holmes observed that the New York Bank's models produced projections of growth in the aggregates over the first half of the year that were in general agreement with those presented by the Board's staff. However, the Bank's judgmental projections of growth in the January-February period and in the first quarter as a whole, based on an assumption of prevailing money market conditions, were lower than those indicated by the Board staff.

Mr. Bucher asked Mr. Holmes whether he agreed with the observation in the blue book that continuation of the heavy calendar of offerings of bonds was likely to lead to a further updrift in long-term rates in the event that the Federal funds rate remained about where it was.

Mr. Holmes replied that while the odds favored a slight further upward drift in long-term rates, he was far from certain that rates would rise, in part because savings banks and other investors had large amounts of funds available for investment.

Chairman Burns then proposed that the Committee turn to its discussion of the appropriate course of monetary policy

in the period immediately ahead. In that discussion, it would be necessary to give particular attention to the longer-run targets, and it would be desirable for each Committee member to express his views on that issue.

Mr. Black observed that over the longer term inflation was still the main problem that the Committee had to deal with, but given the rise in petroleum prices and the prospect of sizable increases in wage rates in 1974, some inflation was inevitable no matter what monetary policy was adopted at this meeting. With prices and nominal GNP rising, demands for transactions balances were likely to expand, and the strengthening of the dollar in foreign exchange markets also might increase the demand for money, at least temporarily. If the System did not accommodate some of the expansion in the demand for money, short-term interest rates would rise, and the rise would occur at a time when recession was a clear threat. Consequently, he would accept some upward adjustment in the longer-run targets--to annual rates of 6 per cent for M_1 and 8-1/2 per cent for both M_2 and the credit proxy. Accordingly, he favored alternative B.

Continuing, Mr. Black said the uncertainties with respect to the demand for money in the short run suggested that it would

be wise to focus primarily on money market conditions and temporarily to accept, if necessary, a growth rate for M_1 over the January-February period somewhat in excess of the upper limit of 5-1/2 per cent specified under alternative B. Therefore, he favored the range of 3 to 6 per cent that Mr. Axilrod had suggested. With respect to the Federal funds rate, he would prefer an upper limit of 9-3/4 per cent--rather than the 10-1/4 per cent specified under alternative B--because of the extreme sensitivity of the market, and he would set the lower limit at 8-3/4 per cent. In view of the shortfalls in M_1 growth in recent weeks, it would be prudent to move the rate down to 9-1/2 per cent fairly promptly. He would hold the rate at that level until there had been sufficient time to gauge market reactions and to assess the behavior of the aggregates in this time of considerable uncertainty.

Chairman Burns remarked that Committee members might bear in mind that under the procedures that they had approved at the December meeting, the short-run specifications adopted at this meeting would be shown in the policy record that would be published in 3 months. The members had also agreed that the longer-run targets should be described in qualitative terms. In light of the latter decision, the language of alternative B appeared to be too specific. If the directive said that "the Committee

seeks to achieve bank reserve and money market conditions consistent with growth in monetary aggregates over the months ahead at about the rates that prevailed over the past 12 months," in effect it would say that the longer-run target for M_1 growth was about equal to the 5.9 per cent rate recorded in 1973. He thought it would be better to use some more general language, such as "the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead."

Mr. Daane commented that as the growth rates of alternative B were associated with prevailing money market conditions, the directive might say "To implement this policy, while taking account of the forthcoming Treasury financing and of international and domestic financial market developments, the Committee seeks to maintain prevailing bank reserve and money market conditions consistent with moderate growth in monetary aggregates."

Mr. Hayes noted that the blue book contained language that could be associated with alternative B in the event that the Committee again wished to couch the directive in terms of money market conditions. It said "the Committee seeks to maintain about the prevailing money market conditions, provided

that the monetary aggregates appear to be growing at rates within the specified ranges of tolerance." Personally, he preferred that language.

Chairman Burns remarked that at the December meeting the Committee had adopted a directive couched in terms of money market conditions. He recalled that at the time he had felt some hesitancy--although he had believed that was the right action--because of the possibility that the Committee would slip back into using a directive cast in terms of money market conditions. Use of that form for 2 months in succession might result in an inadvertent change in procedures; if the Committee were going to make such a change, it should do so only after thorough debate.

Mr. Black commented that if the Committee raised its longer-run target from 5-1/4 per cent to 6 per cent, it would be desirable to use language that suggested such a change.

Chairman Burns remarked that no doubt Mr. Broida could suggest appropriate language, but the Committee might not decide to raise its longer-run target for M_1 to 6 per cent. He had reservations about such an increase, and perhaps other members did also.

Mr. Broida observed that if the Committee wished to adopt directive language that gave a flavor of some increase in its longer-run targets, it might call for somewhat faster growth in monetary aggregates than had occurred in the second half of 1973.

Mr. Mayo said he too believed that it would be desirable for the directive to give a flavor of some easing of policy in the event that the Committee adopted alternative B and raised its longer-run target, and he would endorse the language suggested by Mr. Broida. He favored alternative B as a mild and constructive step that was consistent with the outlook for economic activity. It was also consistent with the battle against inflation in that growth in M_1 at a 6 per cent annual rate in the first half of 1974 would still be considerably less than the prospective rate of increase in prices. Like Mr. Black, he would widen the short-run range of tolerance for M_1--specifying 3 to 6 per cent--and he would also widen to 3 percentage points the ranges for M_2 and RPD's. With respect to the funds rate, a range of 9 to 10 per cent would be appropriate, although if demands for bank credit eased--and there were already some signs of such easing--he would rather see the funds rate fall below 9 per cent than see the growth rate for M_1 fall below 3 per cent.

Chairman Burns noted that at the December meeting, the Committee had specified a range of 8-3/4 to 10 per cent for the funds rate.

Mr. Mayo commented that he would have no objection to retention of that range for the period ahead.

Mr. Hayes commented that although the business outlook was still full of uncertainties, it now appeared that the petroleum shortfall might be more moderate than was thought at the time of the Committee's last meeting. The probabilities would seem to favor a relatively mild business slowdown for 1974 as a whole--something considerably short of a serious recession. At the same time the price situation remained dismal; the energy crisis was bound to bring a substantially higher rate of inflation than had been expected prior to the oil embargo, even if the embargo should be terminated in the near future. The Federal budget would probably continue to be relatively stimulative; the international situation was full of great uncertainties; and the monetary aggregates had been growing faster than the long-term path favored by the Committee. Under those circumstances, he could see even less reason now to ease monetary policy than he could last month. Inflation remained the greatest problem, and the Committee should try to lean against

the strong inflationary pressures by keeping about the same policy stance as it had for several months.

Continuing, Mr. Hayes said he greatly preferred a 6-month growth target of 5-1/4 per cent for M_1, as suggested under alternative C. He would accept the 2-month ranges of tolerance of alternative B--or the widened range of 3 to 6 per cent for M_1 that had been suggested. He favored the alternative B range of tolerance of 9-1/4 to 10-1/4 per cent for the funds rate, with the understanding that the Manager would not lower the rate much below the current level unless the aggregates were strikingly weak. As he had said earlier, he preferred to couch the directive in terms of money market conditions.

Mr. Morris remarked that he would accept the Chairman's suggestion that the directive call for "moderate growth" in monetary aggregates. As to the M_1 target, he would support a 6 per cent annual rate of growth over the first half of 1974 because the targeted rate ought to be at least somewhat higher in a recession period than it was in a boom year. However, he had doubts about the suggestion in the staff analysis that the short-run ranges of tolerance for the aggregates associated with a 6 per cent rate of growth in M_1 would be accompanied by little change

or some rise in short-term interest rates. To his knowledge, it would be unprecedented to have growth in the money stock at the projected rate and a decline in real output of goods and services without at the same time having some reduction in short-term interest rates. The staff's hypothesis that, in this period of inflation, a decline in interest rates would be prevented by the public's efforts to maintain the real value of their cash balances was not sufficiently convincing to lead to a policy of status quo with respect to interest rates.

Continuing, Mr. Morris observed that if the Committee pursued such a policy at the beginning of a period of recession out of fear that growth in M_1 otherwise might prove to be excessive, it would be giving insufficient weight to the more likely risk of a shortfall in M_1 growth in the first half of 1974. Such shortfalls in past periods of recession had been characteristic products of Federal Reserve policy. At the present juncture, it would be more prudent to guard against making the major mistake that might result from a policy of stable interest rates. Consequently, he favored the short-run specifications of alternative A with one modification: he would reduce the upper limit for the funds rate to 9-1/2 per cent. Adoption of a range of 8-1/2 to 9-1/2 per cent would, in effect, instruct the Manager

to make a modest move in the direction of a slightly easier environment in the money market. Such a move at this time would provide a degree of insurance against making a major mistake of the kind that might result from holding to stable money market conditions. If the move to a 9-1/2 per cent funds rate appeared to be producing rapid growth in the aggregates, it would be consistent with the Committee's procedures for the Manager to hold the rate at 9-1/2 per cent rather than to move it down any further within the specified range.

Mr. Bucher observed that he agreed with Mr. Morris' remarks. He continued to be concerned about the magnitude of the slowdown in economic activity in prospect for the first half of 1974; he would emphasize the uncertainties created by the energy situation and the apparent danger of a downturn in economic activity simultaneously in most other industrial nations, which could worsen the situation in this country to a degree that probably could not be anticipated. In the existing environment, the System could not afford to take any action that might appear as a move toward a tighter policy posture. As Dr. Otto Eckstein had said--according to the Boston Bank's contribution to the red book[1/]--the role of monetary policy was to avoid compounding the recession.

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

Mr. Bucher remarked that he was extremely concerned about inflation. In his view, however, it was a long-term problem and one that had resulted in part from some unusual factors; it could not be solved in a relatively short period of time. On the other hand, a problem of fairly immediate concern was the heavy calendar of prospective new issues in the corporate bond market. Expansion in business expenditures for plant and equipment--one of the few expansive areas--was being counted on to temper recessionary developments, and any increase in long-term interest rates along with the existing uncertainty in financial markets might provoke many cancellations of new bond issues. Moreover, increases in short- and long-term interest rates might reduce flows of funds into the nonbank thrift institutions, thereby further depressing residential construction activity. Federal Reserve policies should contribute to preventing such developments from adding to the prospective weakening in economic activity. There was a danger that unemployment would rise to a point that would produce an overreaction in terms of fiscal policy, adding to inflationary pressures.

Therefore, Mr. Bucher concluded, the Committee should make another move in the direction of ease. He would be happy

with the alternative B longer-run target of 6 per cent for M_1, and he would not be disturbed if monetary growth in the short run was consistent with the faster long-run growth of alternative A. He endorsed Mr. Morris' suggestion for a funds rate range of 8-1/2 to 9-1/2 per cent, wishing to emphasize that the funds rate should be moved down. With respect to the language of the directive, either the staff's suggestion for alternative B or the Chairman's proposed substitute would be satisfactory; he had not objected to publication of the specifications for the longer-run targets, and he would not now object if the target for M_1 should be revealed in the language of the directive.

Mr. Sheehan commented that the Committee was faced with a very difficult problem because of the nature of current inflationary pressures. Looking back over the 2 years that he had been a member of the Committee, he did not feel that the System had made a significant contribution to the inflation; the rise in prices had resulted much more from such special factors as the devaluations and supply problems affecting foods and fuels than from an overly expansive monetary policy. Thus, he did not agree with the Chairman's acknowledgement--in response to questions at a Congressional committee hearing--that monetary policy may have been too easy. That notion was only correct given perfect foresight, in that the lags in monetary policy required attempting to foresee economic activity 6 to 9 months into the future.

Looking ahead, Mr. Sheehan continued, the Committee had no choice but to validate the rise in prices if it wished to avoid compounding the recession. In his view, the recession had begun about 6 weeks earlier, and real GNP was likely to decline in both the first quarter and the second quarter. And while there had been supply problems for a number of months, which no doubt were continuing, much of the reduction in economic activity had been demand-induced--rather than supply-induced as suggested, to his surprise, by the red book--and supply problems also created demand problems. Demands for autos and housing had weakened even before development of the energy crisis. Now, the rise in prices of fuels and of such fuel-related items as plastics and electric power would have a dampening effect on consumer spending for other goods and services, and reports on consumer attitudes and spending intentions were discouraging. Only the outlook for business capital spending was encouraging.

At the same time, Mr. Sheehan said, dramatic demands for wage increases were in prospect for 1974, in part because of the magnitude of the increase in prices that had already occurred. According to the latest green book, real spendable earnings of production workers had declined through the four quarters of 1973. In the much less inflationary environment of July 1971, the United Steel Workers had negotiated a 31 per cent wage increase spread over the following 36 months. While the Committee ought not to disregard

the problem of inflation, it could not really reduce demands for wage increases very much by permitting a slowdown in economic activity and an accompanying rise in unemployment. As the Chairman had said with respect to the 1970-71 period, the old rules were not working. The economy experienced a mild recession then which had little if any discernible effect on price and wage increases.

Mr. Sheehan remarked that he strongly favored alternative A, although even that alternative did not go as far in the direction of a policy ease as he thought was called for at the present time. He agreed with Mr. Morris' suggestion for a range of 8-3/4 to 9-1/2 per cent for the funds rate. To those who were concerned about the System being accused of contributing to inflation, he would say that they might be far more embarassed in the second half of this year--looking back to this meeting and given the lags in the effects of policy--if the Committee decided now to maintain the funds rate close to 10 per cent, as some of the members desired.

Mr. MacLaury observed that it was time, if not past time, to raise the Committee's longer-run targets, and he would accept a rate of growth of 6 per cent for M_1. Increasing the target raised the issue of whether the Committee would be validating the inflation, but he would note in that context that the 6 per cent M_1 growth rate should be compared with the potential growth rate of 4 per cent in real GNP. Even though the economy was not growing at a 4 per cent rate at the moment, he would argue

that the Committee would be validating only a small proportion of the expected rate of increase in prices.

Chairman Burns commented that the income velocity of money tended to accelerate in periods of inflation.

Mr. MacLaury agreed, but he remarked that the Committee still could not be charged with validating the inflation if it chose a 6 per cent longer-run target for M_1.

Continuing, Mr. MacLaury said another question raised by some observers was why, given the lags in the effects of monetary policy, the Committee should wish to ease policy now when the recession developing in the first half of the year could not be much affected and an upturn was anticipated for the second half. His answer was that he was not convinced that there would be an upturn in the second half, and most of those who expected one did not anticipate that it would be very strong. Therefore, the Committee would not be remiss in raising its longer-run target for M_1 to a 6 per cent annual rate of growth. For the January-February range of tolerance he would accept 3 to 6 per cent. He would maintain the funds rate range of 8-3/4 to 10 per cent adopted at the last meeting, but he would instruct the Manager to move the rate down to 9-1/2 per cent now, with further moves dependent upon incoming data for the aggregates.

Mr. Coldwell observed that it was important to assess whether the weakening in economic activity resulted mainly from a contraction in demand--stemming in part from past actions of the System--or mainly from supply disruptions due to the energy shortage. If the energy problem should be viewed as the main cause, the Committee might approach policy from the point of view of what it could contribute over the longer term as the energy problem diminished. Given the policy lags, a minor move toward an easier policy might be appropriate, but the specifications being suggested appeared to him as a significant rather than a minor shift in the Committee's position. In his view, the Committee would be validating the inflation if it made a significant move at the present time. A demand-induced recession was not yet sufficiently in evidence for the Committee to undertake to restimulate demands; he would be concerned about restimulating the economy and adding to inflationary pressures for the sake of putting a few people back to work.

In considering the targets for the aggregates, Mr. Coldwell commented that early last year developments in exchange markets had contributed to a slowing in growth in M_1, and the strengthening in the dollar in the current period might, in reverse, generate some upward pressure on growth in M_1. While waiting for somewhat

greater visibility with respect to both the energy problem and international financial developments, he would favor a very minor and orderly easing of policy. He would be willing to move the longer-run target for M_1 up to 5-1/2 or 5-3/4 per cent, but he would be concerned about a move all the way up to 6 per cent. He favored 3 to 5-1/2 per cent for the short-run range of tolerance. He preferred a range of 9 to 9-3/4 per cent for the funds rate, hoping that the rate would remain close to 9-3/4 per cent. For the language of the directive, he would not object to Mr. Daane's alternative, with the deletion of the word "prevailing," or if the Committee again wished to give greater emphasis to the aggregates, he could accept the language "the Committee seeks to achieve moderate growth in monetary aggregates with consistent bank reserve and money market conditions."

Chairman Burns remarked that it might be helpful if the Committee's Senior Economist gave his policy recommendation at this point.

Mr. Partee observed that, as he had said in his earlier remarks, the Committee was faced with serious constraints on the policy options available as a practical matter. Like Mr. Morris, he would be more comfortable if interest rates were declining somewhat; the financial situation was a little too tight for the Committee to feel confident that there would be an appreciable

stimulus to housing and other areas dependent upon the availability of long-term funds, so he would like to see long-term rates decline. At the same time, like Mr. Hayes, he would like to see a continuation of quite moderate growth in the aggregates; the Committee would have a better posture, and a better public image, with respect to resisting inflation if it could constrain the expansion in the monetary numbers. The difficulty was that the Committee probably could not have both lower interest rates and moderate monetary growth, and perhaps it could not have either. Given the recent rate of increase in prices and the prospect that the real money stock--which had been declining--would continue to decline at least in the first and second quarters of the year, policy was on the borderline of being restrictive enough to force the economy into recession. At the same time, with growth in nominal GNP continuing relatively high, and with inflationary expectations rampant, there would doubtless be considerable resistance to significantly lower interest rates. Therefore, the Committee might have to tolerate both a little higher rate of growth in the aggregates and somewhat higher interest rates than it otherwise might like to have. With those considerations in mind, he preferred alternative B as the best expression of a middle position.

Mr. Balles commented that at this time it probably would be premature for the Committee to move to a longer-run target of

6 per cent for M_1. As suggested earlier, fiscal policy might become more stimulative, and monetary policy might have to be more conservative than otherwise if the combination of fiscal and monetary policies was to be moderately conservative--as the Chairman had suggested it should be--in the interest of minimizing the chances of adding to inflationary pressures while still cushioning the effects of the energy shortage. The monetary policy response appropriate to a recession induced by a weakening in demand might not be appropriate now. Moreover, an increase in the demand for money in the present situation, while plausible, was still conjectural. Consequently, he would not be too concerned about not easing up on the credit brakes to the degree desired by some other members of the Committee.

Mr. Balles said none of the policy alternatives proposed by the staff seemed appropriate to him. He would prefer to retain the longer-run targets of 5-1/4 and 8 per cent for M_1 and M_2, respectively, that had been adopted at the December meeting. He favored ranges of tolerance of 3 to 6 per cent for M_1 and 5 to 8 per cent for M_2 for the January-February period, and a range of 9-1/4 to 10-1/4 per cent for the funds rate in the period until the next meeting.

Mr. Holland remarked that this was a time to be cautious in easing monetary policy because it was one of those occasions when the System could easily do more to aggravate inflation than

it could to alleviate unemployment. Therefore, he would be comfortable with annual rates of growth in the first quarter of 5-1/4 to 5-1/2 per cent for M_1, about 8 per cent for M_2, and 7 to 8 per cent for M_3. For the second quarter, there were good technical reasons for expecting a bulge in growth in M_1 and, to a lesser extent, in some of the other aggregates--not only because of increased liquidity preference but also because of sizable Government transfer payments. Because of the second-quarter bulge, the alternative B average rate of growth of 6 per cent for M_1 over the first and second quarters combined seemed appropriate, but he would not regard that rate as his longer-run target. The associated rate of growth in M_3 suggested that there would be a degree of financial support to housing that would be helpful but not excessive.

Mr. Holland said he preferred the modified directive language for alternative B suggested by Mr. Broida, a 3 to 6 per cent range for M_1 in the January-February period, and corresponding ranges of 3 percentage points for M_2 and RPD's. With respect to the funds rate, he could accept a range of 8-3/4 to 10 per cent. He regarded the 10 per cent ceiling as particularly important, and at the same time preferred that the Manager be hesitant in aiming for a rate below 9-1/2 per cent; he did not

want changes in the funds rate to signal a shift in policy in either direction. More specifically, a rise in the rate above 10 per cent would be interpreted in the market as a tightening in policy, and to convey that kind of signal at this juncture would not be desirable. At the same time, he would not want the Manager to aim at a rate below 9-1/2 per cent without first consulting with the Chairman so that--in the event of weak enough growth in the aggregates to suggest the desirability of some action--the Board would have a chance to consider reducing reserve requirements. In his view, the instruments of monetary policy were a little out of balance at present, and he would prefer that the Board take the opportunity to reduce reserve requirements, especially the marginal reserve requirement on CD's. In the event that the Board did not act, the lower part of the range for the funds rate, under the Committee's procedures, would be available.

Mr. Francis commented that, in his view, the actual and prospective slowdown in economic activity resulted wholly from capacity, supply, and price-distorting constraints and not from a weakening in demand. Therefore, to ease policy and allow a faster rate of monetary growth would be to increase inflationary pressures without expanding real output or reducing unemployment. From that standpoint, he could not accept any policy alternative

that involved an increase in the longer-run rate of monetary growth. Last spring--after nearly 2-1/2 years of growth in M_1 at an annual rate of more than 7 per cent--the Committee had adopted a longer-run target of 5-1/4 per cent. Over the past half year, growth had been close to the target, and he preferred that it continue at about that rate for a time.

Mr. Eastburn observed that the Philadelphia Bank's latest projections--which were based on assumptions of an improvement in the availability of oil and no increase in the rate of monetary growth--suggested that the outlook for growth in real GNP had improved over the past month while the outlook for inflation had worsened. Those prospects implied that the Committee's longer-run target for M_1 should not be raised more than it already had been in recent months by virtue of the Committee's acceptance of rates of growth in excess of its targets. Starting from the current estimate for December, a 5-1/4 per cent rate of growth over the first half would raise M_1 to a level next June about $1.5 billion higher than would the same rate of growth from the December level estimated just a month ago. Put another way, the projected increase in M_1 from the old December level to the June 1974 level shown under alternative C represented a 6-1/2 per cent annual rate of growth.

With those considerations in mind, Mr. Eastburn said, he preferred alternative C. However, he did have some concern about the possible effects on short-term interest rates; he suggested, therefore, that the Desk probe toward the 5-1/4 per cent M_1 path, but that it let M_1 exceed that path if necessary to avoid undue increases in short-term rates. A range of 9-1/4 to 10-1/4 per cent for the funds rate would be reasonable.

Mr. Kimbrel remarked that he continued to be concerned about the availability of industrial materials, about the rate of inflation, and about pressures in international markets. Hopefully, the Committee's action would not contribute to expansion in demands for scarce goods and services but rather would contribute to an improvement in consumer confidence. If growth in M_1 continued close to the rates of 10.4 and 8.5 per cent reported for November and December, respectively, the public was not likely to believe that relaxation in monetary policy was only slight. Believing that it would be premature to raise the longer-run targets, he favored an annual growth rate of 5-1/4 per cent for M_1, as specified under alternative C. Otherwise, he favored the specifications of alternative B, although he would accept the widening of the short-run range for M_1 to 3 to 6 per cent, as had been suggested by Mr. Axilrod. He hoped that within the range of 9-1/4 to 10-1/4

per cent, the funds rate would not move much from its current level. With respect to the operational paragraph of the directive, he had preferred the language of alternative B couched in terms of money market conditions, but in light of the Chairman's earlier remarks, he would not hold strongly to that position.

Mr. Brimmer said he was taken with Mr. Partee's policy recommendation, although he would not go quite so far in raising the longer-run target. The Committee should anticipate the second-quarter bulge in M_1--which Mr. Holland had called attention to--but that did not require the establishment of 6 per cent for the 6-month target at this juncture. The potential impact of the tax refunds could be reviewed again at the Committee's meeting in February. Apart from the longer-run target, he would favor the specifications of alternative B; the funds rate range of 9-1/4 to 10-1/4 per cent seemed reasonable.

Mr. Mitchell observed that Messrs. Partee and Holland had expressed his own views rather well. His main concern in determining policy was to avoid disintermediation. As others had said, it was necessary to reverse the decline in residential construction this year in order to promote recovery in economic activity, and the decline would not be reversed if the nonbank thrift institutions experienced outflows of funds. In the present

situation, then, it was the rate of growth in M_3--rather than in M_1--that really counted. With respect to the language of the directive, he could accept either of the suggestions for alternative B that had been put forward by Mr. Daane and Mr. Broida.

Mr. Clay commented that this nation had a very long memory for the depression of the 1930's and it lacked any real understanding of the damage that inflation could do to the economy and to the future of the people. As a result, actions to halt a developing recession tended to be taken immediately while actions to halt inflation were delayed interminably. The current situation was an example in that there was a willingness to validate the inflation in order to avoid a slowdown in economic activity and a rise in unemployment. The Administration had already announced a projected deficit of $10 billion in the budget for fiscal year 1975, describing it as the minimum stimulus needed in view of the weakening in the economy. Moreover, the Administration suggested that it would stand ready to provide additional fiscal stimulus in the event that the weakening proved to be worse than expected.

Continuing, Mr. Clay said fiscal policy had prompt effects on the economy. Monetary policy, in contrast, affected economic activity with a lag, so that any easing in policy undertaken at this time might very well affect developments some 6 months in

the future when economic activity was indicated to be moving up again. In light of those developments and prospects, the following was the most important statement in the latest green book: "But despite the accelerated pace of earnings increases (in the last three quarters of 1973), rising prices have completely eroded the purchasing power of take-home pay for the individual worker." Inflation was still the major problem.

Mr. Clay observed that given the inflation and a stimulative fiscal policy, the question was just how stimulative monetary policy should be. In his view, policy should not be directed toward an immediate turnaround in economic activity, for in that effort to achieve full employment, the Committee would be neglecting its responsibility to pursue economic stability over the longer term. Achievement of economic stability would enhance the possibilities of sustaining full employment. Thus, he would not increase the Committee's longer-run target for monetary growth, and he favored alternative C.

Mr. Daane said the current situation was unique in terms of the nature and causes of the domestic and international uncertainties and in terms of the particular reasons for experiencing both rising unemployment and increasing inflationary pressures. The uncertainties and the forces at work in the economy were of

such magnitude that they far outweighed the impact of any directive likely to be given to the Manager today, and they far outweighed the choice between a 5-3/4 and a 6 per cent longer-run target for M_1. In light of the remarks others had made about validating the inflation and augmenting inflationary pressures on the one hand, and of increasing recessionary tendencies in the economy on the other hand, he was inclined to believe that there was a tendency to exaggerate the role and influence of the instructions given to the Manager for operations over the period of a few weeks.

Continuing, Mr. Daane noted that against the background of uncertainties, the Treasury would be engaged in a major quarterly refunding. His experience as a debt manager suggested that, while the particular financing now appeared uncomplicated, it could become complicated because of the uncertainties in the situation. With those thoughts in mind, he had proposed alternative language for the operational paragraph of the directive that stressed prevailing money market conditions. Like Mr. Holland, he believed that this was not a time to give a signal of a change in policy in either direction. Prevailing money market conditions were consistent with moderate growth in the monetary aggregates.

Mr. Winn remarked that perhaps an appropriate policy at this time was one of no change, and there had to be enough flexibility to handle any kind of unexpected financial flows that might occur because of the international situation. Therefore, he favored staying with the longer-run targets of alternative C, and he thought that--given the tendency to overshoot the targets that Mr. Eastburn had called attention to--the Committee would be fortunate if in the January-February period the aggregates grew within the short-term ranges of alternative B.

Chairman Burns observed that he had expressed his views about the current economic situation quite fully at the last meeting of the Committee, and he saw no reason now to change those views. In essence, monetary policy could make only a marginal contribution toward stimulating production and employment in the present circumstances. The System should make that contribution, but it should do so with the awareness that for the most part the economy was suffering from a shortage of oil and other materials rather than from a shortage of money. As he had indicated in the session last evening, the recent appreciation of the dollar in exchange markets would help to ease inflationary pressures in this country, and in that respect, it was a welcome development. If the United States could pursue fairly conservative

fiscal and monetary policies over the next few months, at a time when the dollar was likely to remain relatively strong in foreign exchange markets, significant headway might be made in the fight against inflation. That would be an extraordinary achievement--one that would be of immeasurable benefit to the country over the next few years.

For the immediate future, the Chairman said, he believed it would be a mistake to raise the longer-run target for M_1 growth as high as 6 per cent. However, some increase in the target was indicated by the developing recession--which was partly demand-induced. While he personally would be agreeable to an increase in the target to either 5-1/2 or 5-3/4 per cent, he thought the higher figure came closer to representing a consensus of the members' views. With respect to the directive language, he would recommend calling for bank reserve and money market conditions consistent either with moderate growth in monetary aggregates or with somewhat faster growth in monetary aggregates over the months ahead than occurred during the second half of 1973. The latter formulation was vague, considering that, on the basis of the revised figures, M_1 grew at an annual rate of 3.9 per cent in the second half of last year, but perhaps it would indicate that the Committee

intended some slight easing. For the short-run ranges of tolerance, he would recommend the following annual rates of growth for the January-February period: 4-3/4 to 7-3/4 per cent for RPD's, 3 to 6 per cent for M_1, and 6 to 9 per cent for M_2. For the weekly average Federal funds rate in the period until the next meeting, he would recommend a range of 8-3/4 to 10 per cent. He would accept Mr. Morris' suggestion that the Manager be instructed to move the rate down rather promptly, but he would modify the suggestion to provide that the Manager do so only if the figures that would become available on Thursday of this week did not indicate rapid growth in the monetary aggregates. If the figures indicated no more than moderate growth, the Manager should aim to reduce the rate rather promptly by 1/4 percentage point, into a range of 9-1/4 to 9-1/2 per cent.

Chairman Burns suggested that the Committee consider the several recommendations separately. Informal polls might be taken first on the longer-run targets and then on the short-run ranges of tolerance for the aggregates he had suggested.

The polls indicated that a majority of the members considered acceptable both the longer-run targets and the short-run operating ranges the Chairman had recommended.

The Chairman then proposed that the members express their preference with respect to the operational paragraph of the directive. A majority of the members indicated that they would accept the language that the Chairman had suggested, namely, "the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead."

In response to a question by the Chairman, Mr. Holmes noted that the latest reading for the funds rate was 9-1/2 per cent but that the rate had been around 9-5/8 per cent in the last couple of days; so far in the current statement week, through yesterday, the rate had averaged about 9-9/16 per cent.

Chairman Burns then suggested that the Committee consider first the range of tolerance for the weekly average funds rate and then the more specific instructions to the Desk that he had mentioned earlier. He proposed that the Committee retain the range of 8-3/4 to 10 per cent that it had adopted at the December meeting Although he would not want to see the rate move up to 10 per cent, it would be desirable to provide some room for maneuver in the event that incoming data indicated explosive rates of growth in the monetary aggregates in the January-February period.

A majority of the members indicated that they favored the range of 8-3/4 to 10 per cent.

The Chairman next asked for views on the suggestion that the Manager be instructed to move the rate down rather promptly, aiming to reduce it by 1/4 of a percentage point into a range of 9-1/4 to 9-1/2 per cent, provided that the figures becoming available on Thursday did not indicate rapid growth in the monetary aggregates.

Noting the proposed proviso concerning the aggregates, Mr. Daane asked whether the Manager should also be instructed to back off from the effort to reduce the funds rate in the event that market rates began to drop precipitately in reaction to the System's operations.

Chairman Burns responded that in the event of a sharp drop in market rates, it would be appropriate to permit a modest decline in the funds rate rather than to attempt to freeze it.

Mr. Holmes observed that a few months earlier, a very modest decline in the funds rate had been accompanied by a drop of a full percentage point in the 3-month Treasury bill rate. In the period ahead, however, System actions were likely to have less impact on the market. The outlook for the availability of reserves in the next 2 weeks was good, and if the projections were correct,

the System would not have to be a net supplier of reserves. The market was not likely to react as strongly as it would if the System had to be an active supplier of reserves in order to move the funds rate down from 9-5/8 per cent.

A majority of the members concurred in the Chairman's recommentation regarding the more specific instructions to the Manager.

Chairman Burns proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and the language he had suggested for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following specifications. The longer-run targets--namely, annual rates of growth for the first and second quarters combined--would be 5-3/4, 8, and 8 per cent for M_1, M_2, and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the January-February period would be 4-3/4 to 7-3/4 per cent for RPD's, 3 to 6 per cent for M_1, and 6 to 9 per cent for M_2. The range for the weekly average Federal funds rate in the inter-meeting period would be 8-3/4 to 10 per cent.

Mr. Hayes said he planned to dissent from the proposed directive because he could not accept an increase in the longer-run target for M_1 and he did not want a range for the funds rate

that was skewed to the low side of the rate that had prevailed in recent days.

Mr. Francis said he also planned to dissent; he favored the policy course he had outlined earlier.

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

The information reviewed at this meeting indicates that growth in real output of goods and services was slow in the fourth quarter of 1973, in part because of the fuel situation. Prices continued to rise sharply in December, reflecting additional increases for petroleum products and widespread advances among other goods and services. A further weakening in activity and sharp rise in prices appear to be in prospect for early 1974. In December nonfarm payroll employment changed little, and the unemployment rate increased further. Wage rates have continued to rise substantially in recent months, although not so sharply as prices.

Major foreign currencies have depreciated further against the dollar since mid-December, and some foreign monetary authorities have continued to sell dollars in exchange markets. Steep price increases imposed by oil-producing countries have heightened fears of economic disruption in many countries and of large and erratic international flows of funds.

The narrowly defined money stock increased substantially in the last 2 months of 1973, partly reflecting increased foreign deposits, but it has changed little on balance over recent weeks. Net inflows of consumer-type time deposits remained sizable at both banks and nonbank thrift institutions. Bank credit expansion, which was moderate over the closing months of 1973, has accelerated in recent weeks as banks have stepped up issuance of large-denomination CD's. Since mid-December, interest rate movements have been mixed;

yields on most long-term securities and on Treasury bills have risen on balance, while some private short-term rates have declined.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, cushioning the effects on production and employment growing out of the oil shortage, and maintaining equilibrium in the country's balance of payments.

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

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

Chairman Burns then noted that two memoranda from the Secretariat, regarding the release of the 1968 Committee minutes, had been distributed on January 14, 1974.[1/] He asked Mr. Broida to comment.

Mr. Broida said the staff recommended that the Committee authorize the release of its 1968 memoranda of discussion and

1/ The first of the two memoranda, from Mr. Broida, was entitled "Release of 1968 FOMC minutes." The second, from the Secretariat, was entitled "Passages recommended for deletion when 1968 minutes are initially released." Copies of both memoranda have been placed in the Committee's files.

actions in the same manner as employed for earlier minutes--that is, by transmitting the original signed copies to the National Archives, where microfilm copies would be made available for sale, and placing bound reproductions in the libraries at all Federal Reserve offices. During the period in which the microfilm and bound copies were being prepared, "work copies" would be made available for public inspection in the libraries of the Board and the New York Bank.

As in past years, Mr. Broida continued, it was recommended that certain sensitive passages--all of which were in the foreign currency area--be withheld when the minutes were initially released. The proposed deletions, and suggested footnotes indicating the general nature or subject of each deleted passage, were shown in an appendix to the second of the two memoranda distributed. He might call to the Committee's particular attention the proposal to withhold the text of a letter from Secretary of the Treasury Fowler to Chairman Martin relating to Treasury backstop facilities for System swap drawings, which had been appended as an attachment to the memorandum of discussion for July 16, 1968. The Treasury had asked that that letter, as well as certain of the textual references to backstop facilities in memoranda for earlier meetings in 1968, be withheld on the grounds that their publication

at this time could make difficulties for the United States in international negotiations.

Mr. Daane noted that there was a question in his mind as to whether certain additional references to the Fowler-Martin letter should not also be withheld.

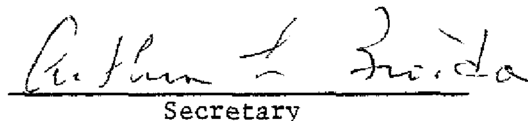
During the ensuing discussion, Mr. Mitchell remarked that he had not yet had an opportunity to study the staff's recommendations.

Chairman Burns observed that he also had not examined those recommendations in detail. While he would be prepared to accept the judgment of the remaining members regarding them, he thought such judgments should be carefully considered. Accordingly, he suggested that the matter be held over until the Committee's next meeting.

There was general agreement with the Chairman's suggestion.

It was agreed that the next meeting of the Committee would be held on Wednesday, February 20, 1974.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

January 21, 1974

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on January 22, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting indicates that growth in real output of goods and services was slow in the fourth quarter of 1973, in part because of the fuel situation. Prices continued to rise sharply in December, reflecting additional increases for petroleum products and widespread advances among other goods and services. A further weakening in activity and sharp rise in prices appear to be in prospect for early 1974. In December nonfarm payroll employment changed little, and the unemployment rate increased further. Wage rates have continued to rise substantially in recent months, although not so sharply as prices.

Major foreign currencies have depreciated further against the dollar since mid-December, and some foreign monetary authorities have continued to sell dollars in exchange markets. Steep price increases imposed by oil-producing countries have heightened fears of economic disruption in many countries and of large and erratic international flows of funds.

The narrowly defined money stock increased substantially in the last 2 months of 1973, partly reflecting increased foreign deposits, but it has changed little on balance over recent weeks. Net inflows of consumer-type time deposits remained sizable at both banks and nonbank thrift institutions. Bank credit expansion, which was moderate over the closing months of 1973, has accelerated in recent weeks as banks have stepped up issuance of large-denomination CD's. Since mid-December, interest rate movements have been mixed; yields on most long-term securities and on Treasury bills have risen on balance, while some private short-term rates have declined.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, cushioning the effects on production and employment growing out of the oil shortage, and maintaining equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of the forthcoming Treasury financing and of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat faster growth in monetary aggregates over the months ahead than has occurred during the past year.

Alternative B

To implement this policy, while taking account of the forthcoming Treasury financing and of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with growth in monetary aggregates over the months ahead at about the rates that prevailed during the past year.

Alternative C

To implement this policy, while taking account of the forthcoming Treasury financing and of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat slower growth in monetary aggregates over the months ahead than has occurred during the past year.

ATTACHMENT B

January 22, 1974

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 1/22/74)
A. Longer-run targets (SAAR) (first and second quarters combined)	M_1	5-3/4%
	M_2	8%
	Proxy	8%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (January-February average):		4-3/4 to 7-3/4%
2. Ranges of tolerance for monetary aggregates (January-February average):	M_1	3-6%
	M_2	6-9%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		8-3/4 to 10%
4. Federal funds rate to be moved in an orderly way within range of toleration.		

5. Other considerations: account to be taken of the forthcoming Treasury financing and of international and domestic financial 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. It was understood that the Desk would seek rather promptly to achieve reserve conditions consistent with a Federal funds rate in the 9-1/4 to 9-1/2 per cent range, provided that the data becoming available later in the week of the meeting did not suggest that the monetary aggregates were growing rapidly.